IRS ENFORCEMENT OF THE REPORTING OF TIP INCOME

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

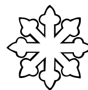
ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

JULY 15, 2004

Serial No. 108–67

Printed for the use of the Committee on Ways and Means



U.S. GOVERNMENT PRINTING OFFICE

99–685 WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON WAYS AND MEANS

BILL THOMAS, California, *Chairman*

PHILIP M. CRANE, Illinois
E. CLAY SHAW, JR., Florida
NANCY L. JOHNSON, Connecticut
AMO HOUGHTON, New York
WALLY HERGER, California
JIM MCCRERY, Louisiana
DAVE CAMP, Michigan
JIM RAMSTAD, Minnesota
JIM NUSSLE, Iowa
SAM JOHNSON, Texas
JENNIFER DUNN, Washington
MAC COLLINS, Georgia
ROB PORTMAN, Ohio
PHIL ENGLISH, Pennsylvania
J.D. HAYWORTH, Arizona
JERRY WELLER, Illinois
KENNY C. HULSHOF, Missouri
SCOTT MCINNIS, Colorado
RON LEWIS, Kentucky
MARK FOLEY, Florida
KEVIN BRADY, Texas
PAUL RYAN, Wisconsin
ERIC CANTOR, Virginia

CHARLES B. RANGEL, New York
FORTNEY PETE STARK, California
ROBERT T. MATSUI, California
SANDER M. LEVIN, Michigan
BENJAMIN L. CARDIN, Maryland
JIM MCDERMOTT, Washington
GERALD D. KLECZKA, Wisconsin
JOHN LEWIS, Georgia
RICHARD E. NEAL, Massachusetts
MICHAEL R. MCNULTY, New York
WILLIAM J. JEFFERSON, Louisiana
JOHN S. TANNER, Tennessee
XAVIER BECERRA, California
LLOYD DOGGETT, Texas
EARL POMEROY, North Dakota
MAX SANDLIN, Texas
STEPHANIE TUBBS JONES, Ohio

Allison H. Giles, *Chief of Staff*
Janice Mays, *Minority Chief Counsel*

SUBCOMMITTEE ON OVERSIGHT

AMO HOUGHTON, New York, *Chairman*

ROB PORTMAN, Ohio
JERRY WELLER, Illinois
SCOTT MCINNIS, Colorado
MARK FOLEY, Florida
SAM JOHNSON, Texas
PAUL RYAN, Wisconsin
ERIC CANTOR, Virginia

EARL POMEROY, North Dakota
GERALD D. KLECZKA, Wisconsin
MICHAEL R. MCNULTY, New York
JOHN S. TANNER, Tennessee
MAX SANDLIN, Texas

Pursuant to clause 2(e)(4) of Rule XI of the Rules of the House, public hearing records of the Committee on Ways and Means are also published in electronic form. **The printed hearing record remains the official version.** Because electronic submissions are used to prepare both printed and electronic versions of the hearing record, the process of converting between various electronic formats may introduce unintentional errors or omissions. Such occurrences are inherent in the current publication process and should diminish as the process is further refined.

C O N T E N T S

Page

Advisory of July 8, 2004, announcing the hearing 2

WITNESSES

Internal Revenue Service, William F. Conlon, Director, Reporting Compliance 43

American Gaming Association, and Aztar Corp., Joseph J. Jablonski 23
Marriott International, Inc., Edward A. Rosic, Jr. 12
National Restaurant Association, and K-Bob's USA, Inc., Edward R. Tinsley .. 16
Power & Power, Tracy J. Power 8
The Salon Association, and Zona Salons, Frank Zona 28

SUBMISSION FOR THE RECORD

Darden Restaurants, Inc., Orlando, FL, Richard J. Walsh 61

IRS ENFORCEMENT OF THE REPORTING OF TIP INCOME

THURSDAY, JULY 15, 2004

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:22 a.m., in room 1100, Longworth House Office Building, Hon. Amo Houghton (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
July 08, 2004
No. OV–15

CONTACT: (202) 225–7601

Houghton Announces Hearing to Review the IRS Enforcement of the Reporting of Tip Income

Congressman Amo Houghton (R–NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing to review the Internal Revenue Service (IRS) enforcement of the reporting of tip income. **The hearing will take place on Thursday, July 15, 2004, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:15 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include representatives of the IRS, the National Restaurant Association, The Salon Association, and an individual from the gaming industry.

BACKGROUND:

Over the last decade there has been significant growth in the service industries. In 1994, tip wages reported to the IRS totaled $8.52 billion, and in 2003, this number grew to just over $18 billion. Despite the increase in reported income, the IRS estimates that unreported tip income may exceed $9 billion annually. The IRS first addressed the issue of compliance with its creation of the Tip Reporting Determination/Education Program (TRD/EP) in 1993. The TRD/EP was designed to educate employers and employees in the service industry about tip reporting laws in order to increase compliance.

Businesses may voluntarily participate in one of two types of agreements, the Tip Reporting Alternative Commitment (TRAC) or the Tip Rate Determination Agreement (TRDA). The TRAC emphasizes employee education and tip reporting procedures. Employers must agree to assume responsibility for having their employees report tips, and the IRS agrees to not assess the business employment taxes on unreported tips unless the employees are examined first. The TRDA requires the determination of tip rates using historical data that the IRS works with the employer to establish. Employees are required to sign an agreement with their employer that they will report tips at or above a determined rate established by the employer and the IRS. Under the TRDA, the employer reports non-compliant employees to the IRS, but is not required to educate the employees on reporting tips. The TRDA agreements have become common in the gaming industry.

In December of 2000, the IRS began to offer a third option called the Employer-designed Tip Reporting Alternative Commitment (EmTRAC). The EmTRAC contains the same elements of TRAC, but goes a step further by giving the employer the latitude to train and educate their employees of their responsibility to properly report tip income. Currently, EmTRAC is only available to the food and beverage industry and each individual plan needs to be approved by the IRS. Depending on its success, EmTRAC may be expanded to cover other service industries.

In June of 2002, the U.S. Supreme Court heard the case of *United States v. Fior D'Italia, Inc*., 122 U.S. 2117 (2002). The central question involved whether current law authorized the IRS to assess a restaurant for employment taxes based upon tips their employees may have received, but failed to report. The Court held that the IRS is authorized to use an aggregate estimation method when a restaurant or business underreports its tip income, and that employers could be held liable for taxes beyond what their individual employees reported for tips. The aggregate estimation method uses overall credit card charges to determine the average percentage tip rate paid by the customer. This rate is then applied to the total sales reported on the annual Form 8027. The restaurant is then required to pay this percentage based on cash tips. Employers in the restaurant and other service industries have argued that it is unfair to assess them using the aggregate estimation method and hold them liable if their employees are not accurately reporting their tip income. They argue that it is unfair to assume cash tips are the same as credit card tips.

Legislation has been introduced to address some of the problems surrounding audits and the aggregate estimation method. Representative Wally Herger (R–CA) introduced H.R. 2034, the "Tip Tax Fairness Act of 2003," which would require an accurate evaluation of unreported tips by the IRS. In addition, the bill would bar the IRS from conducting employer-only aggregate assessments for the purpose of determining Federal Insurance Contribution Act (FICA) taxes on underreported tip income. Representative Nancy L. Johnson (R–CT) introduced H.R. 2133, the "Cosmetology Tax Fairness and Compliance Act of 2003," which would extend to the cosmetology industry the nonrefundable income tax credit for employer-paid Social Security taxes on employee cash tips to meet Federal minimum wage requirements. The tax credit allows businesses to offset part of the taxes they pay on the tip income of their employees. Under current law, Section 45B of the Internal Revenue Code provides a tax credit for employers only in the food and beverage industry.

FOCUS OF THE HEARING:

The hearing will examine IRS enforcement of tip reporting, the progress of the TRDA, TRAC, and EmTRAC agreements, proposed legislation addressing the restaurant and salon industries, and solutions to increase compliance from employers and employees in the service industries.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov,* select "*108th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=16*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record.*" Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Thursday, July 29, 2004. **Finally,** please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and sub-

mitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quote d or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman HOUGHTON. The hearing will come to order. We thank you very much for coming. Particularly our witnesses in the panels. We are here today to review the IRS (IRS) programs that encourage the reporting of tip income. Over the last 10 years, the service industry has grown significantly, and many service employees receive a good portion of their income from tips. The IRS has estimated that a very significant amount of these tips remain unreported. I believe that everyone needs to pay their fair share of taxes, and I hope we can explore today how to improve compliance with the law.

Two Members of our Committee, Mr. Herger and Mrs. Johnson, have introduced bills that would do a variety of different things to address issues of tip-reporting in the service industry. We are going to hear from a panel of witnesses which includes: an individual who worked with the IRS in developing one of their tip compliance programs, as well as litigated a relevant U.S. Supreme Court case; second, a representative from the National Restaurant Association (NRA); thirdly, an individual from Marriott International; and then a representative from both the Gaming Association and the Salon Association (TSA). One of the witnesses on this panel is a restaurant owner who created his own successful tip-reporting compliance program. We are certainly interested in hearing how he has done this.

On the next panel, we are going to hear from a representative from the IRS, who will provide us with background on the tip-reporting issue and explain how compliance is progressing. I look forward to hearing from the witnesses, and I am hopeful that this hearing will provide the Members with a better understanding of the reporting of tip income. I now yield to the Ranking Member, Mr. Pomeroy, for any statement he would like to make.

[The opening statement of Chairman Houghton follows:]

Opening Statement of The Honorable Amo Houghton, Chairman, and a Representative in Congress from the State of New York

Good morning. We are here today to review the IRS programs that encourage the reporting of tip income. Over the last 10 years the service industry has grown sig-

nificantly. Many service employees receive a good portion of their income from tips. However, the IRS has estimated that a significant amount of these tips remain unreported. I believe that everyone needs to pay their fair share of taxes, and hope we can explore today how to improve compliance with the law.

Two Members on the Committee have introduced legislation addressing issues of tip reporting within the service industry. Rep. Nancy Johnson introduced a bill that would extend to the cosmetology industry a nonrefundable income tax credit, which is currently only available to the food and beverage industry. Rep. Wally Herger introduced a bill that would require the IRS to conduct an accurate evaluation of unreported tips and bar the use of employer-only aggregate assessments for the purpose of determining FICA taxes on underreported tip income.

First, we will hear from a panel of witnesses which includes an individual who worked with the IRS in developing one of their tip compliance programs, as well as litigated a relevant Supreme Court case, a representative from the National Restaurant Association, an individual from Marriott International, and a representative from both the gaming industry, and The Salon Association. One of the witnesses on this panel is a restaurant owner who created his own successful tip reporting compliance program. We are all interested in hearing how he does this.

On the next panel, we will hear from a representative from the IRS, who will provide us with background on the tip reporting issue and explain how compliance is progressing.

I look forward to hearing from the witnesses and I am hopeful that this hearing will provide Members with a better understanding of the reporting of tip income.

I now yield to the ranking Member, Mr. Pomeroy, for any statement he wishes to make.

Mr. POMEROY. Mr. Chairman, thank you for convening this hearing. We on the Subcommittee on Oversight, I think, find today's inquiry squarely in the middle of our strike zone in terms of what ought to be the function of the Subcommittee on Oversight. In 1982, Congress passed legislation to provide the IRS with new measures to identify unreported tip income, and at that time it was estimated that about 85 percent of the income occurring in this sector went unreported. Two decades later, IRS reports that very significant improvement in tip-reporting compliance has been made. In fact, we have seen tips from all industries reported increase from $8.5 billion in 1994, to $18 billion in 2003. These voluntary compliance partnerships between the private sector and the IRS have shown some considerable success.

The IRS has entered into approximately 14,000 agreements with restaurant employers because employers recognize by being part of one of these agreements, the business can significantly decrease the likelihood of future IRS audits of related records. The first panel is going to bring us private sector information in terms of how this is going, and the second panel is the IRS responding to it. It is absolutely in reverse of how we usually do our business, because usually we have the agency first followed by the private sector. I think that this morning's session can maybe be almost more of a dialog format with putting on the record how it is working, the upsides, the downsides, where the frustration is—and there is frustration as evidenced by the legislation that our colleagues have introduced. I think it is going to be very interesting for us to get the learning curve that the first panel will bring us and then the learning curve of the IRS response. In the end, we want to strike a fair balance among taxpayer rights, small businessowner needs, and tax enforcement. I hope that today's discussion is going to bring us some advanced understanding in terms

of whether this balance is presently achieved relative to tip-reporting income. Thank you, Mr. Chairman, for holding this hearing.

[The opening statement of Mr. Pomeroy follows:]

Opening Statement of The Honorable Earl Pomeroy, a Representative in Congress from the State of North Dakota

The goal of today's Oversight Subcommittee hearing is to examine the IRS's current tax administration policies for encouraging employer and employee compliance in the reporting of and paying of taxes on tip income.

In 1982, Congress passed legislation to provide the IRS with new measures to identify unreported tip income. At that time, it was estimated that about 85 percent of tip income went unreported by workers in food and beverage, beauty and barber, gambling, and taxicab businesses.

Two decades later, IRS reports indicate that there has been a significant improvement in tip reporting compliance. Tips reported from all industries have risen from $8.5 billion in 1994 to $18 billion in 2003. This is largely attributed to the private sector working closely with the IRS to improve tax reporting by employers and employees. It is my hope that this coordination will continue and improve even further.

Currently, there are three voluntary IRS programs through which employers can establish tip reporting and tax payment compliance mechanisms. These programs—the Tips Reporting Alternative Commitment (TRAC), the Tip Rate Determination Agreement (TRDA), and the Employer-designed Tip Reporting Alternative Commitment (EmTRAC)—have had some success operating on a volunteer basis. The IRS has entered into approximately 35,000 agreements with restaurant employers, for example, because employers recognize that by being part of one of these agreements, a business can significantly decrease the likelihood of future IRS audits of related records.

The first panel of witnesses today, representing the restaurant, cosmetology, and gaming industries, will discuss the successes and failures of these programs from their experiences. I hope that, as a result of this hearing, we will bring to light some of the problems these types of businesses are facing in complying with the law and that additional dialogue between the parties and the IRS may take place to resolve these issues.

On the second panel, we will have the senior IRS official in charge of tax reporting compliance. Among other issues, he will discuss how the various tip-reporting programs operate to the benefit of employers, employees, and efficient tax administration. In addition, for firms that have not chosen to enter into voluntary agreements with the IRS, he will discuss the importance of the recent U.S. Supreme Court decision supporting the IRS's practice of estimating unreported tip income for purposes of calculating an employer's liability for Social Security and Medicare taxes.

I thank and commend Chairman Houghton for holding this hearing. This is an issue that clearly has significance to small businesses as well as their employees, and I know this is the case in North Dakota where I represent thousands of small business owners and employees. In discussing this issue, we need to ensure that we strike a fair balance among taxpayer rights, small business needs, and tax enforcement. I am pleased that the Oversight Subcommittee is examining the matter.

Thank you Mr. Chairman.

Chairman HOUGHTON. Well, thank you. Now, Mrs. Johnson, would you like to make a statement or make any introductions?

Mrs. JOHNSON. Thank you very much, Mr. Chairman. I will not be able to stay for your hearing, but I really wanted to come and thank the Committee for holding a hearing on this issue because it is important that everyone pay their fair share of taxes. I have been working for several years now with the salon industry because of the unevenness with which the IRS is functioning in their industry, creating, really, disparities of impact on small businessowners. I am very glad to welcome Frank Zona here from Massachusetts, who is representing the salon industry. What struck me was the difference between how we are dealing with that issue in hairdressing versus how we have dealt with it in res-

taurants. While it took us many years to get to some kind of reasonable agreement with the restaurant industry, I think this hearing and the relationships that this Committee has developed with the IRS will give us an opportunity to work with these small businesspeople to create a better not only communication system and better understanding, but some better solutions. Thank you very much, Chairman Houghton and Mr. Pomeroy and all the Members of the Committee, for holding this hearing, and I wish you well and look forward to working with you. Thank you, Frank, for coming.

Chairman HOUGHTON. Thank you very much. Mr. Tanner, would you like to say something?

Mr. TANNER. Thank you very much, Mr. Chairman. I want to just welcome you all here. Mr. Herger and I have been working together on this issue for what, Wally, 3 years now, 4 years? We are interested in it. We look very much forward to what you have to say to try to help us straighten this thing out. Thank you.

Chairman HOUGHTON. All right. Mr. Herger, would you like to make any comment?

Mr. HERGER. Thank you, Mr. Chairman and Ranking Member, for scheduling this hearing. This is an issue of great importance to millions of restaurant employees and employers across America. Our interest in Congress is making sure that employment taxes are paid on tip income and that the IRS is enforcing the law in a manner fair and equitable to both employers and employees. I believe the question we should be asking ourselves today is: how do we create the proper environment for employers, employees, and the IRS to best manage this admittedly difficult issue? Like many small business restaurant owners, I am troubled by the IRS aggregate assessments based on an assumed amount of unreported tips. Along with Congressman Tanner and others, I have introduced legislation that would prohibit the IRS from imposing these aggregate assessments with the hope of moving the IRS toward a more accurate determination of taxes owed. I am hopeful that this hearing will serve as a forum to discuss with Congress and the IRS what we can do to improve the collection of taxes on tip income. Again, I thank you, Mr. Chairman.

[The opening statement of Mr. Herger follows:]

Opening Statement of The Honorable Wally Herger, a Representative in Congress from the State of California

I want to thank the Chairman and Ranking Member for scheduling this hearing. This is an issue of great importance to millions of restaurant employers and employees across America. Our interest in Congress is making sure that employment taxes are paid on tip income, *and* that the IRS is enforcing the law in a manner fair and equitable to both employers and employees.

I believe the question we should be asking ourselves today is how do we create the proper environment for employers, employees, and the IRS to best manage this admittedly difficult issue. Like many small business restaurant owners, I am troubled by IRS aggregate assessments based on an assumed amount of unreported tips. Along with Congressman Tanner and others, I have introduced legislation that would prohibit the IRS from imposing these aggregate assessments, with the hope of moving the IRS toward a more accurate determination of taxes owed. I am hopeful that this hearing will serve as a forum to discuss what Congress and the IRS can do to improve the collection of taxes on tip income.

Chairman HOUGHTON. All right. Now, let me introduce the first panel. Tracy Power, Partner at Power & Power; Edward Rosic, Vice President and General Counsel of Marriott International; Edward Tinsley, Chief Executive Officer (CEO), K-Bob's USA, Inc., and Treasurer of the NRA; Joseph Jablonski, Executive Director of Aztar Corporation in Phoenix; and Frank Zona, whom Mrs. Johnson introduced, Government Affairs Co-Chair, TSA. We would appreciate if you would begin your testimony Ms. Power.

STATEMENT OF TRACY J. POWER, PARTNER, POWER & POWER

Ms. POWER. Thank you, Mr. Chairman and Members of the Subcommittee. I am honored to be here and pleased to have an opportunity to comment on the IRS' tip-reporting enforcement policy. I would like to give you a little bit of insight into my familiarity with this issue, briefly mention precisely what the IRS is doing, and then talk about what is right and what is wrong with it. I am a tax attorney representing the restaurant industry on a variety of issues. I have been counsel of record for seven of the cases that have been brought on the IRS' aggregate estimate method in the courts. I represented Fior d'Italia before the Supreme Court along with my partner and father. I am one of the principal authors of the IRS' Tip Reporting Alternative Commitment (TRAC) agreement. I have also advised and consulted with well over 50 companies on how they should institute and implement tip-reporting procedures in order to comply with the TRAC agreement. I have some familiarity with the broad spectrum of IRS' response on this issue and with the differing operational problems that restaurateurs face in dealing with this problem.

I would like to briefly comment on what the IRS does. The IRS reviews the data on the Form 8027, which is a one-page form that the restaurateur files each year with the IRS. That form contains information as to sales, charge sales, charge tips, tips reported. The IRS will look at that information and, for instance, if a restaurateur has sales of $1 million, it will assume that there is a 15-percent overall tip rate, that 8 percent of the tips are being reported, 7 percent is unreported, and the IRS will assess the employer the employer's share of Federal Insurance Contributions Act (FICA) taxes on that 7 percent of unreported tips, or $70,000. The IRS goes further and now claims that they can go back 16 years on that assessment.

For a unit that grosses about $2 million a year, not an atypical amount, that is $170,000 which has to be deposited within 3 days after being served the notice and demand because it is FICA taxes. For a 500-unit chain, that is $86 million that has to be deposited within those 3 days. The IRS uses this amount or the published potential for exposure to this liability to require the employer to track, monitor, and police the reporting of employees' tips. There are a number of things wrong with this aggregate assessment approach.

First, the potential exposure is devastating. It is ongoing and it continues to grow. The employer is blindsided by it. He had no clue when the last was passed in 1988 that this was the potential exposure. Second, the employer does not have and never has had the records to defend against this type of assessment. Most small oper-

ators would not even know where to begin to challenge it. Third, the assessment is inherently inaccurate. The IRS often fails to acknowledge that there is a significant difference between charge tips and cash tips. Gross receipts on the Form 8027 include amounts that often are not subject to tipping, such as carry-outs, employee meals, manager meals. Even the charge tip rate on the 8027 is not an accurate indication of the true charge tip rate.

Next, this is wrong because it is used to push the employer into doing something he just simply is not capable of doing: monitoring and policing the reporting of tip income by employees. Tips vary by employees. In one of the cases that we litigated, the tips ranged from 7 to 23 percent. An employer has no way of knowing which employee received which amount. Employees tip out. They tip out at their own discretion in varying amounts to varying different indirectly tipped employees, such as busboys, bartenders, and hostesses. The employer cannot force the employee to report, and there are many logical reasons and legal reasons for why the employee might not report his tips to the employer. The employer also runs the risk of significant penalties under section 7434 of the Tax Code if the employer does attempt to make the employee report what he does not earn. Ultimately, the employee is harmed if the employer throws up his hands and says everyone will just simply report at 15 percent.

Last, this aggregate assessment procedure is unnecessary. The significant increase in tip-reporting since the IRS has adopted and implemented the TRAC agreement is indicative of the fact that the aggregate assessment procedure is unnecessary. The entire amount of that increase from 1994 to 2002 was generated without an aggregate assessment threat because the IRS during the course of this time had a moratorium against the aggregate assessment threat. For these reasons, we encourage the Committee to adopt the proposed change to section 3121(q). Thank you very much.

[The prepared statement of Ms. Power follows:]

Statement of Tracy J. Power, Partner, Power & Power

Thank you Mr. Chairman and Members of the Subcommittee. I am honored to be here and pleased to have the opportunity to speak with your committee about the IRS enforcement policy with respect to the reporting of tip income. I believe IRS's current enforcement policy with respect to tip reporting is unfair to employers, unfair to tipped employees, and unnecessary. Today's testimony will highlight some of the reasons why.

By way of introduction I have represented the restaurant industry and its individual members on tip reporting matters for over 20 years. I filed the first lawsuit challenging IRS's aggregate estimation method for assessing the employer share of FICA taxes on unreported tips ten years ago. I represented Fior d'Italia on that issue before the U.S. Supreme Court in 2002 and many other taxpayers in the various circuits in between time. In 1994, I approached IRS on exploring alternatives to employer only aggregate assessments and authored, with several other representatives of the industry and the Service, IRS's Tip Reporting Alternative Commitment (TRAC). Over the last 10 years I have consulted with more that 50 industry leaders on tip reporting and TRAC compliance. I hope my experience with such a broad cross section of the industry will shed some light on the array of problems that employers face with respect to employee tip reporting and what's wrong with IRS's aggregate assessment method so that realistic and workable expectations can guide the Committee's consideration of this issue.

The collection of taxes on tip income has presented a serious administrative difficulty for the IRS. For more than 50 years, Congress and IRS have been grappling with the problem.

Since under state and federal labor and common law, tips are the sole and exclusive property of the employee, paid by customers directly to employees, and shared among employees in varying unknown amounts, Congress has repeatedly and consistently refused to permit the employer to become involved in the tipping transaction or to hold the employer responsible for the accounting of tip income. Instead, Congress placed the responsibility for reporting tip income squarely on tipped employees. In turn, Congress armed the IRS with the power and means to investigate employee underreporting of tip income and to enforce accurate reporting by employees.

IRS has not been happy with the arrangement, however, and has continually attempted to shift its own burden of determining unreported tip income to the employers of tipped employees on the basis of a misconception that the restaurant is "in an inherently better position than the IRS to determine what its employees actually earned in tips." (See the Brief for the United States before the Supreme Court in *United States v. Fior D Italia* pg. 38). This fundamental misunderstanding has led to numerous clashes between IRS and the restaurant industry, manifested in the history of the relevant statutes.[1] At every turn however, Congress has intervened and rejected IRS's attempts to place this onus on employers, affirming that the admittedly difficult job of determining unreported tip income rests not with the employer, but with IRS.

IRS's current enforcement policy with respect to tip reporting, the cornerstone of which is the threat of an assessment based upon an estimate of aggregate unreported tips of all employees collectively, is simply IRS's latest re-invention of its efforts to effectively force the employer into undertaking obligations for, verifying, investigating, monitoring, and policing compliance by its employees—responsibilities which Congress has considered, evaluated, and steadfastly refused to transfer from IRS to the employer. The Supreme Court's holding in *Fior d'Italia,* sanctioning IRS's aggregate assessment authority, overturns Congress's long standing policy considerations underlying the respective roles of employers and IRS with respect to the policing of the reporting of tip income by employees.

Armed with the Supreme Court's blessing, IRS has re-instigated it's long dormant aggregate estimate assessment policy and is currently actively using the threat of a potential assessment for employer FICA taxes on an aggregate estimate of unreported tips of all employees collectively, against which employers have no defense in the absence of the necessary employee information as to actual tips received,to effectively force the employer to be responsible for the accurate reporting of employee tip income through IRS's tip compliance program. The potential assessment is financially devastating, inherently inaccurate, and inconsistently assessed. The alternative, for the many reasons Congress has considered over the last 50 years, is unrealistic and virtually unworkable. The ultimate harm is to the employee and the entire process is unnecessary to increase the compliance of tip reporting.

The IRS's threatened assessment is for the 7.65% employer share of FICA taxes on the difference between reported tips and the actual tipping rate of the establishment as determined by IRS for the now 16 year period since the employer first became liable for FICA taxes on all tips received, whether reported or not, by virtue of the 1987 amendments to IRC § 3121(q). For a unit with a tipping rate of 15% and a reporting rate of 8%, the assessment for the 16 year period would equal 8.6% of sales (7 % unreported tips X 7.65% FICA X 16 years). On a not atypical sales volume of $2 million the potential assessment is $172,000. For a 500 unit chain with $1 billion in sales the potential assessment is $86 million. Since these are FICA taxes, the amount would have to be deposited with the next regular payroll tax deposit (e.g. 3 days) after the notice and demand is issued. While the 45B credit for FICA taxes paid on tips may be available to offset some or eventually all this amount, it is unlikely to do so immediately as average industry profits are only 4% of sales and the potential assessment is more than twice this amount. If annual taxes are 30% of annual profits of 4% or 1.2% of sales, it would take more than 7 years before the 45B credit would fully offset a potential FICA tax assessment of this magnitude.

The assessment, based upon an estimate of tips earned by all employees in the aggregate from data provided annually to IRS by the employer on Form 8027 is also inherently inaccurate. For example, there is no way to determine under IRS's aggregate calculation how much, if any, of the aggregate unreported tip income was tip income received by an individual employee amounting to less than $20.00 a month, 26 U.S.C. 3121(a)(12), nor how much of the aggregate unreported tip estimated by IRS was received by individual employees which when added to such individual em-

[1] The Supreme Court brief of Fior d' Italia (pg 2–12) sets forth the history of IRS's enforcement efforts with respect to tip income and Congress's response.

ployee's other wages paid by the employer exceeded the wage base, 26 U.S.C. 3121(a)(1). This is information only the employee has.

Nor does use of the Form 8027 data tell one whether individual employees received tips net of credit card fees often charged by many employers or whether employees received any tips on "employee meals" or "carry-out" sales, figures often included in a restaurant's gross receipts on Form 8027 but upon which tips are seldom received. Nor would such a methodology provide information about a company's policy with respect to "walk-outs" or "stiffs," figures often included in gross receipts for financial purposes then expensed, but upon which tipping is unlikely. Nor would an aggregate assessment based on Form 8027 data give any information as to whether a portion of a restaurant's sales are self-service or buffet at different times of the day, factors which would vastly affect the tip rate.

IRS does not even know whether the amount designated as a tip on a charge receipt was in fact a tip. For example, IRS does not know to what extent customers use the tip line to procure cash to purchase cigarettes or to pay for valet parking or, as in some establishments, to feed video games—information which can obviously only be procured from the employee himself. IRS does not know whether the aggregate tips reported on Form 8027 included credit card amounts which were uncollectible for which the employer sought reimbursement from the employee.

The IRS's assessment is also based on the charged tip rate even though IRS takes no steps determine if other factors such as the use of coupons, gift certificates or two for one offers artificially inflate that rate and even though IRS's own studies show that cash tips are significantly less than charged tips. These flaws permeate IRS's aggregate estimating methodology and for the most part the employer is wholly without the information (which he was not privy to in the first place) to challenge them. The actual amount of tips retained by employees and the data and records to substantiate that amount is solely within the employees' control and has never been available to the employer. Indeed, many state labor laws prohibit the employer from having any involvement in the tipping process whatsoever.

IRS nevertheless uses the threat of this inherently inaccurate and financially devastating assessment to effectively force the employer to ensure full and accurate reporting by employees to the employer. However, since tips are most often given to employees directly from customers in varying amount based upon an individual employee's ability and personality and then split with indirectly tipped employees (e.g., hostess, busboys, bartenders, bread girls, etc.) in varying amounts at the discretion of the directly tipped employees, without any involvement of the employer, it is virtually impossible for the employer to know the amount of tips received by individual employees and assure accurate reporting of that amount.

In addition, reporting to the employer is not the only means by which an employee may declare his tipped income. An employee may declare his tips directly on his income tax return through the use of Form 4137, a form specifically designed for this purpose. There is no penalty for an employee's failure to report his tips to the employer and instead report his tip income directly to IRS on his tax return by use of Form 4137 as long as his failure is due to reasonable cause and not wilful neglect. 26 U.S.C. 6652(b). There are many legitimate, logical, practical, and lawful reasons why an employee may not report all his tips to the employer pursuant to 6053(a), yet still declare them for income tax purposes on Form 4137 when filing his income tax return.

The restaurant business is a very transient business with employee turnover rates of 200–400%. Many employees cease working for the employer long before the time to report even rolls around—certainly a legitimate reason for not reporting to the, now ex-, employer.

There are also many reasons an employee may not want the employer to know the total amount of tips retained. An employee may be afraid that if the employer knows the total amount of tips he receives, the employer may reduce his station or hours in favor of other employees, thereby reducing his income. A directly tipped employee may share a substantial portion of his tips with a hostess in return for seating the better tipping customers in his section or with a chef for giving his favored customers the best cut of meat—practices which neither the directly nor indirectly tipped employee would be keen about the employer discovering.

For these reasons and many others there would be nothing unusual in the total amount of tips reported by employees to employers being less than total credit card tips or less than expected. Similarly, for these reasons and many others the employer is not in a position to ensure the accuracy of employee reporting.

The only practical solution to an employer forced to do so, and secure protection from an IRS threat of a financially devastating tax assessment, is to find a way to force its employees to report at the level IRS seeks. Satisfying IRS's stated goals of average industry tip reporting at 14½%, when industry statistics indicate the ac-

tual figure is substantially less, but employers are without the necessary data to support a lower amount, will inevitably mean that many employees will be required to report more in tips than they actually earn, making their effective tax rate one of the highest in the country. The fact that the aggregate estimate assessment fails to credit employees with a wage earning history for social security benefit purposes for the tips IRS claims they make and that it does nothing to further the collection of the employees share of taxes on the tips received should also not be overlooked as an inherent flaw in this enforcement methodology.

Despite the flaws in the enforcement policy, the potential harm it poses to employers and employees alike and the fact that it leaves 75% of the tax dollars at issue on the table, IRS insists the aggregate assessment method is an essential component of its enforcement effort. IRS argues that in it absence it would be required to conduct individual audits of employees at considerable expenditure of agency resources with little results.

The significant increase in tips reported from 1994 through 2002 when IRS had a highly publicized self-imposed moratorium on the use of the aggregate assessment method, belies IRS's contentions and demonstrates that the threat of an aggregate assessment is wholly unnecessary to assure tip reporting compliance. Moreover, IRS has many options available to it short of individual employee audits to increase employee tip reporting.

Certainly IRS could collect a substantial amount of its alleged shortfall by simply sending employers a bill for their share of FICA taxes on the additional tips their employees report on Forms 4137 (see infra pg. 6). Additional amounts could also readily be collected by pursuing by letter, the list of employees provided IRS annually to whom an allocation was made, as intended by Congress in enacting the 8% tip allocation provision. To the extent perceived additional unreported amounts warrant further pursuit, "desk" audits could be undertaken by sending the identified employees computer generated assessments for amounts in excess of the allocation. At least then, employees could defend against such proposed assessments and employers could avail themselves of the defenses employees have brought to bear against IRS assessments.

All of these options are available to IRS at minimal time and expense with the crucial distinction of identifying individual employees and amounts of any additional tip earnings of individual employees so their wage earnings records for social security benefit purposes could be credited for such additional amounts with greater assurances that the amounts assessed were actually received by the individual employees.

Aggregate estimate assessments are unfair to employees because without the necessary employee records, employers are deprived of an effective means to defend against inflated assessments. The historical practices of tips being received directly from customers and tip sharing among employees make it impossible for the employer to assure the accuracy of employee tip reporting. Requiring the employer to do so will effectively mean requiring all employees to report at a flat, administratively workable rate—grossly unfair to the employees who do not make that amount. These results can not be sanctioned when the aggregate estimate method has proved to be totally unnecessary to increasing tip reporting compliance and when IRS has many more palatable options at its disposal to solve unreporting problems.

For these reasons we support HR 2034 and urge its passage.

Chairman HOUGHTON. Thanks very much, Ms. Power. Mr. Rosic?

STATEMENT OF EDWARD A. ROSIC, JR., VICE PRESIDENT AND ASSISTANT GENERAL COUNSEL, MARRIOTT INTERNATIONAL, INC., BETHESDA, MARYLAND

Mr. ROSIC. Good morning, Mr. Chairman and Members of the Subcommittee. Thank you for giving me the opportunity to appear today. I am Ed Rosic, testifying on behalf of Marriott International. Marriott is a leading worldwide hospitality company with over 2,700 lodging properties and over 128,000 employees. In the mid-nineties, Marriott joined a group of hotel and restaurant industry members to work with the IRS to develop a program that would

be an alternative to the IRS' enforcement strategy for reporting tip income. The result was the TRAC program, that Ms. Power referred to. The TRAC program is an outstanding example of the IRS working with the taxpayer community to produce a viable alternative to address the concerns of both the U.S. Department of the Treasury and many in the business community. For many employers, it has provided a framework for improved compliance with the tax rules governing tip income.

The development of the TRAC program with the IRS was a very significant undertaking, and the implementation of TRAC required a major commitment on Marriott's part. The change to comply with the TRAC requirements involved Marriott investing significantly in systems; revamping procedures in payroll accounting and the food and beverage operations; production of new human resources operating procedures and development of communication and educational materials. The decision to implement TRAC also required taking risks in employee relations and in the company's ability to compete in the labor market for talent. As you can imagine, some individuals might think it more attractive to work for a company that is not interested in compliance.

Under TRAC, the employer makes a series of substantial commitments: to establish procedures for tracking all of the tip reports by the employees; to educate and periodically update the employees as to their tip-reporting obligations; to file all the required employment tax and information returns and timely pay the taxes; and to maintain certain tip-reporting records and submit to compliance reviews of those records at the IRS' request. The IRS in turn makes commitments under the TRAC program: to assess the employer for its share of employment taxes on unreported tips only based on employee data gathered by the IRS from individual employee tax returns or audits of those employees; to revoke the TRAC agreement retroactively only if the employer fails in the two main commitments it makes on education and recordkeeping; and to revoke the TRAC agreement prospectively in the event the employer fails to satisfy the reporting and payment requirements, and then only on the basis of employee unreported tips if the IRS determined based on an examination that there has been substantial and collective underreporting by employees for two continuous quarters.

These substantial commitments on the part of employers and the IRS under TRAC form the basis for cooperation and effective improvement in the reporting of tip income. Under this program, Marriott has been given positive marks by its IRS examination team because since we joined the TRAC program, the dollar amount of reported tips has nearly tripled on a sales increase of only 47 percent. As part of Marriott International's tip-reporting education efforts, the company has produced a number of tools, including brochures, managers' guides, posters, paycheck stuffers, and most recently, online tutorials. While Marriott has found the TRAC program to be worthwhile and successful, there are some aspects of the rules relating to tip-reporting that could be improved to ease the burden on employers and make tip-reporting compliance efforts more efficient and effective for both the IRS and employers. The current information reporting requirements are fairly rigid and are unnecessarily burdensome to some employers. The tip

and sales information is required to be maintained on the basis of individual food or beverage outlets. For many employers who operate multiple outlets at a single location, maintaining the data at the outlet level is expensive, can interfere with business operations, and produces records with no incremental value to the compliance effort. Many employers would find it more practical if the option were provided to maintain tip and sales information by business location rather than on an outlet-by-outlet basis. This option would substantially reduce the recordkeeping burden but preserve the integrity of the information and compliance effort.

It would also be useful for employers participating in the TRAC program, or variations of it, if uniform education and training materials were available through the IRS in a user-friendly manner but with content that has broad acceptance and that employers would be able to adopt or adapt to their particular situation. In conclusion, the TRAC program has been a real success for both Marriott International and the IRS and demonstrates that cooperative efforts by industry and government can yield positive results. It is our hope that the IRS extends the program beyond the end of 2005, hopefully indefinitely. Thank you.

[The prepared statement of Mr. Rosic follows:]

Statement of Edward Rosic, Vice President and Assistant General Counsel, Marriott International, Inc., Bethesda, Maryland

Thank you for the opportunity to submit this statement. I am Edward Rosic, testifying on behalf of Marriott International, Inc. Marriott International is a leading worldwide hospitality company with over 2,700 lodging properties in the United States and 68 other countries and territories. The company is headquartered in Washington, D.C., and has approximately 128,000 employees and was ranked as the lodging industry's most admired company and one of the best places to work for by FORTUNE®.

In 1994 and 1995, Marriott International joined a group of hotel and restaurant industry members to work with the Internal Revenue Service to develop a program that would be an alternative to the Service's enforcement strategy for reporting of tip income. The result was the Tip Reporting Alternative Commitment or TRAC program. The TRAC program is an outstanding example of the Service working with the taxpayer community to produce a viable alternative to address concerns of both the Treasury Department and many in the business community. For many employers, it has provided a framework for improved compliance with the tax rules governing tip income.

The development of the TRAC program with the IRS was a very significant undertaking, and the implementation of TRAC required a major commitment. The change to TRAC required our company's investment in systems; revamping of procedures in payroll accounting, and food and beverage operations; production of new human resources operating procedures and development of communication processes and materials. Moreover, the decision to implement TRAC required taking risks in employee relations and in the company's ability to compete in the labor market for talent as individuals might think it more attractive to work for a company not interested in compliance.

Under TRAC, the employer makes a series of commitments:

- To establish procedures for tracking all tips reported by employees to the employer;
- To educate and periodically update directly and indirectly tipped employees as to their obligation to report all their tips;
- To file all the required employment tax and information returns and to timely pay the taxes; and
- To maintain certain tip reporting records and to submit to compliance reviews of those records at the Service's request.

The IRS also makes commitments under TRAC:

- To assess the employer for its share of employment taxes on unreported tips only based on employee data gathered by the IRS from individual employee tax returns or audits of the individual employees;
- To revoke the TRAC agreement retroactively only if the employer fails to substantially comply with the employer's commitments on education or tip-reporting procedures; and
- To revoke the TRAC agreement prospectively in the event the employer fails to satisfy the reporting and tax payment commitment or, on an establishment-by-establishment basis, if the IRS determines that the employees of an establishment have collectively and substantially underreported tip income for at least two continuous calendar quarters.

These substantial commitments on the part of employers and the IRS under a TRAC agreement form the basis for cooperation and effective improvement in the reporting of tip income. Under this program, Marriott has been given positive marks by its IRS examination team because since we joined the TRAC program the dollar amount of reported tips has nearly tripled, while applicable sales increased 47%.

As part of Marriott International's tip reporting education efforts, the company has produced a number of tools, including:

- "100% Tip Reporting" brochures in English and Spanish;
- A leader's guide to conducting tip reporting educational meetings at new establishments or for newly hired employees;
- Posters and paycheck stuffers highlighting the tip reporting obligation;
- A form for employees to sign acknowledging attendance at a tip reporting training meeting (English and Spanish versions);
- An on-line tutorial for newly hired employees or as a refresher course for existing employees to teach the tip reporting requirements; and
- An on-line tutorial about tip reporting compliance for managers and human resources professionals.

While Marriott International has found the TRAC Program to be very worthwhile and successful, there are some aspects of the rules relating to tip reporting that could be improved to ease the burden on employers and make tip reporting compliance efforts more efficient and more effective for both IRS and employers:

- Current information reporting requirements are rigid and can be unnecessarily burdensome to some employers. The tip and sales information is required to be maintained on the basis of individual food or beverage outlets. For many employers who operate multiple outlets at a single location or in close proximity, maintaining the data at the outlet level is expensive, interferes with business operations and produces records with no incremental value to the compliance effort.
- Many employers would find it more practical if the option were provided to maintain tip and sales information by business location rather than by individual food & beverage outlet at a given business location. This option could substantially reduce the recordkeeping burden, while preserving the integrity of the information and compliance effort.
- It would be useful to employers participating in the TRAC program, or variations of it, if uniform education and training materials were made available through the IRS in a user-friendly manner and with content that has broad acceptance and that employers would be able to adopt or adapt. Now that the program is nearly 9 years old, a renewed effort for industry-IRS cooperation on education and training materials could be useful.

In conclusion, the TRAC program has been a real success for both Marriott International and the IRS and demonstrates that cooperative efforts by industry and government can yield positive results. It is our hope that the IRS extends the program beyond the end of 2005, hopefully indefinitely.

Chairman HOUGHTON. Thank you very much, Mr. Rosic. Mr. Tinsley?

STATEMENT OF EDWARD R. TINSLEY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, K-BOB'S USA, INC., ALBUQUERQUE, NEW MEXICO, AND TREASURER, NATIONAL RESTAURANT ASSOCIATION

Mr. TINSLEY. Thank you, Chairman Houghton and distinguished Members of the Committee, for allowing me to testify on behalf of the NRA. My name is Ed Tinsley, and I am Chairman and CEO of the K-Bob's steakhouse chain. We are located in Texas, Oklahoma, Colorado, and New Mexico. We employ about 1,000 people system-wide in our steakhouses, of which about 40 percent are tipped employees. I am also the current Treasurer of the NRA.

In addition to representing the industry and urging the Tip Tax Fairness Act, the passage of this is offering some insights into the problems faced by restaurant operators in complying with tip agreements, and I also would like to share some personal perspectives on a program that we have developed in our company to help encourage tip-reporting. I have had the honor of testifying before Congress on one other occasion, so I know the rule: be brief and get to the point. I think Congressman Pomeroy can relate to this because he is—I already mentioned he represents some ranchers. If you have a long rope, it will get you in trouble. You need a short rope and a fast horse.

The reason we are supporting the Tip Tax Fairness Act is when the Supreme Court upheld the IRS' ability to conduct employer-only audits and aggregate assessments, they indicated in that opinion that they felt like Congress would ultimately need to decide this. In most cases, aggregate assessments inflate the employer's liability and leave employers with little to no choice or recourse of how to challenge an assessment. Employers cannot prove or disprove whether employees receive a certain amount of any tipped income. I know of no other industry or business where the IRS places such an onerous burden upon employers and managers in this manner. The burden also adds tension and is destructive to a relationship where we both have common goals, the IRS and business.

As an industry, the NRA and the restaurant industry, we pride ourselves on being employers to 12 million people nationwide. We are the largest private employer in the country. Forty percent of all America's workforce today worked in our industry at one time. Twenty-seven percent of all employees, this is their first-time job through our industry, so that goes without saying that we believe in education, and it goes down the ranks, whether it is teaching the basic work skills of how to show up to work, teaching hygiene, teaching serve safe, but it also incorporates teaching tip-reporting and we are committed on the educational side.

What is creating more concern for employers is the fact that the Supreme Court decision has given the IRS a new license to go forth and assess with even less responsibility to create an accurate assessment. I would be happy to elaborate on this during questions and answers, but it is basically what Tracy alluded to. It is guesswork as to what the actual tips are, and that is just not right. The precedent set by this decision has restaurants nervous and looking for ways to minimize their exposure to such an assessment, which brings me to the TRAC. The TRAC was designed to improve tip-

reporting among our industry by requiring employers to implement education and recordkeeping. However, the devil is in the details.

I chose not to sign a TRAC agreement with the IRS for two basic reasons. One is I do not like signing a contractual agreement with an entity that does not have my company's best interest at heart. Second, I do not like signing an agreement with a company that I have to do business with that has the propensity to change personnel up and down frequently, because it is always a new deal, it is a new date every time you go in. I think those problems are what really stem from my decision to create our own program inhouse.

I think also, too, there is still a significant exposure that remains even after you do sign a TRAC agreement because there is no retroactive protection, and there is inconsistent indications from the IRS as to how that retroactive issue will be handled. We also understand that the TRAC program will sunset in 2005, and there has been also no indication from the recent Supreme Court decision also, too, that this will be extended in any manner. That also is pretty much of a disincentive to the IRS to continue with the TRAC program. There are instances in our industry and in our association where certain companies have been held to higher standards once they have signed the TRAC agreement, performance standards that go beyond what the TRAC agreement actually says. I will expound on that in questions and answers if you would like.

Last, the due process issue with TRAC agreements is almost like this: the IRS serves as the prosecutor, the judge, and the jury, and that makes it very difficult. Our program that we implemented was based on a lot of these concerns. What we did is we set up an employee benefits program that addresses tip-reporting, but it addresses a program that we wanted to show our employees that we care about their future and their welfare, and that is called K-Care. What we do as a company is we match 5 percent of all reported tips into a mutual fund that is shared then across-the-board with all employees in the steakhouse, whether they are the dishwasher, the hostess, or what, based on the hours that they work.

We also have a vacation earnings module that is pertinent to K-Care that enables a server, when they report more tips, their hourly wage is more, so they earn more vacation earnings each quarter. We have seen a 25- to 30-percent increase in our tip-reporting over the last 4 to 5 years because of this. I feel like that if industry can come up with a solution and implement it through proper marketing efforts and assistance from the IRS, that could be an answer. Employers struggle with how to balance the issues with the IRS and those challenges that we have in maintaining a positive relationship, at the same time how to manage and operate a small business. We do not wake up every morning patting our fingers saying, how can we help the IRS collect their taxes? We are worried about payroll. We are worried about leases. We are worried about food costs and all of those things and providing jobs.

I think the only method that we have left is for Congress to help clarify this issue and get away from what aggregate assessments have done in deteriorating the intent of the TRAC agreement. We do not want to be the IRS police any more than you would in your previous businesses back home, or if you do have a business back

home. I do not think it is our responsibility, nor should it be the employer's, to be the IRS police. I thank you for this opportunity to testify.

[The prepared statement of Mr. Tinsley follows:]

Statement of Edward R. Tinsley, CEO, K-Bob's USA, Inc., and Treasurer, National Restaurant Association, Albuquerque, New Mexico

Chairman Houghton and distinguished Members of the committee, thank you for inviting me to testify today on behalf of the National Restaurant Association about the restaurant industry's ongoing concerns with the Internal Revenue Service's enforcement practices with regard to tipped income.

I am the President and CEO of K-Bob's USA, Inc., a steakhouse chain with locations throughout New Mexico, Texas, Oklahoma and Colorado. Systemwide we employ roughly 1000 people, of which 40 percent are tipped employees. Currently, I am the Treasurer for the National Restaurant Association.

Although I am here today to represent the National Restaurant Association, I have also been asked to talk about the K-Care program, a unique initiative I created that has resulted in increased tip reporting among my employees.

By way of background, we want to remind the committee on the history of this issue.

In 1988, Congress required employers to begin paying FICA payroll taxes on *all* employee tips. Congress concluded that tipped employees earn a substantial portion of their income through tips. Therefore, Social Security benefit payments should be determined with respect to the entire amount of tips, and Congress determined that employers should be subject to tax on all tips, so that the employees' wage earnings records can be properly credited.

In 1993, Congress enacted a federal tax credit to provide some relief from paying a matching FICA tax on tips given by customers to restaurant servers. The so-called 45(B) credit allows employers to claim a federal income tax credit for the FICA taxes they pay on any tips above the minimum-wage tip credit. In regulations, the IRS limited the scope of this credit to (1) tips reported by employees and (2) tips received after January 1, 1994.

Congress further clarified the law, rejecting the IRS' interpretation, in the 1996 minimum wage/tax bill by allowing restaurateurs to claim the credit for FICA taxes paid after January 1, 1994, on both reported and unreported tips, and regardless whether those tips were received before or after January 1, 1994. This clarification was necessary because many employers are made to pay additional FICA taxes based on IRS's tip audits and assessments, as a consequence of employee underreporting of tips.

In determining tax liability on unreported tips, the IRS uses an "employer-only" aggregate assessment method, whereby the agency looks at a restaurant's records, primarily credit card tips' receipts, to come up with a *total* amount of tips it thinks all employees should have reported. The IRS then bills the *restaurant-operator* for the employer's share of FICA taxes (currently 7.65%) on any allegedly unreported tips, but does not examine individual employees' records or credit employer FICA tax payments to individual employees' Social Security accounts.

The IRS's approach has been challenged in a number of court cases. In June, 2002 the U.S. Supreme Court took up the issue and upheld the practice based on the Court's inability to find a definite expression of congressional intent to prohibit the IRS from conducting such "employer-only" audits and aggregate assessments. In its opinion, the Court invited the industry to seek legislative action to clarify congressional intent behind the law.

The National Restaurant Association believes Congress never intended to grant the Internal Revenue Service (IRS) the authority to use aggregate assessments to bill employers for FICA payroll taxes on allegedly unreported tips. The Association believes statutory language is needed to clarify Congressional intent for the following reasons:

1. The purpose of paying FICA taxes is to create a wage history for individuals to draw future Social Security benefits. When the IRS issues an aggregate assessment for FICA taxes owed on unreported tips, the amount paid by the employer is never credited to the employee's social security wage records.
2. Aggregate estimates inaccurately inflate an employer's tax liability. In making these aggregate estimates, the IRS assumes—quite often, incorrectly—that (1) customers who pay cash for their meals tip at exactly the same percent as customers who pay by credit card; (2) *all* tipped employees fail to report their tips;

(3) *all* tipped employees fail to report the same amount; (4) customers never "stiff" their servers—i.e., leave them no tip.

3. The IRS's "employer-only" approach puts the burden of enforcing tip-reporting laws on employers, rather than the IRS. It places on employers the unique burden of *disproving* either that employees underreported their tips or the amount underreported. Justice Sandra Day O'Connor asked the government attorney representing the IRS in the Supreme Court case, *Fior d'Italia v. U.S.,* how an employer could disprove employees' underreporting of tips? The IRS' attorney told her during oral argument that the only way she could imagine this being done was for employers to hire "honest employees."

The Honorable Wally Herger and the Honorable John Tanner, both distinguished Members of this committee, have introduced legislation to help clarify congressional intent. H.R. 2034, the Tip Tax Fairness Act, would prohibit the IRS from imposing *aggregate* assessments for FICA taxes owed on allegedly unreported tips. The IRS would have to establish the actual amount of tips that were unreported. Further, the intent of the legislation is to ensure that the IRS credit assessments paid by employers for FICA taxes owed on unreported tips to the individual employee's wage credit accounts for purposes of the employee's Social Security benefits.

The Association appreciates the effort Congressman Herger and Congressman Tanner have put forth on behalf of tipped industries. Passage of this legislation represents a top priority for the Association.

Given the association's legal battles and legislative efforts, it would appear as if we have an adversarial relationship with the IRS. However, it is quite the contrary. Over the years, we have enjoyed a mutually respectful working relationship. I am a witness to that, having worked with the IRS on the concept of a non-contractual tip reporting agreement, which the IRS later rolled out as its new "EmTRAC" program. The IRS has worked closely with the Association to make improvements to the agency's tip reporting programs and IRS higher level staff have been available on many occasions to meet with our member restaurants to discuss problems with tip reporting programs, such as the TRAC and EmTRAC. In return, the Association has spent a considerable amount of resources educating members about their employees tip reporting obligations. The Association created a tip reporting kit for restaurateurs to use to help comply with the TRAC agreement. And, at the request of the IRS, the Association now recommends, and has since the year 2000 that members seriously consider signing the TRAC or EmTRAC, as a means of protecting their restaurants from an employer-only audit and assessment.

Until the time that our fundamental disagreement over the IRS employer-only practices are resolved via the legislation, the Association will work on ways to provide employers more complete protection from their current exposure to an employer-only audit and assessment.

It is important to point out that restaurateurs currently have certain limited options that can *minimize* but do not eliminate their potential exposure to an employer audit and assessment. First, as mentioned, Congress passed in 1993 a tax credit for employers that pay FICA tax on servers' tips. The so-called the 45(b) tax credit, however, cannot be applied to all taxpayers. Like most other credits and deductions, it cannot be taken by taxpayers filing under the alternative minimum tax, a growing predicament for more and more restaurateurs every year. Alternately, the credit cannot be applied when a taxpayer has no tax liability, i.e. they did not have a profitable year. According to National Restaurant Association statistics, only 40 percent of restaurant companies with tipped employees take advantage of the 45(b) tax credit. Second, and in addition to the 45(b) tax credit mentioned earlier, restaurateurs can enter into a tip reporting agreement with the IRS. The agreement requires the agency to conduct employee tip examinations before assessing an employer for back FICA taxes owed, in exchange for the employer's commitment to educate employees about their tip obligations and maintain records on the employee's tips (discussed below). However, employers are not completely sheltered by this option either.

Another potential option is for an employer to enter into a tip reporting agreement with the IRS. The most widely used program offered to restaurant operators is the Tip Reporting Alternative Commitment or TRAC. Under the TRAC, an employer agrees to advise his or her workers of tip-reporting requirements, implement procedures by which employees report tips, maintain specific records, and comply with tax reporting, filing and payment requirements. In return, the IRS agrees to not conduct employer-only audits and assessments against the employer for the time period the employer is under TRAC. However, the TRAC has numerous drawbacks.

Consider the fact that there are roughly 225,000 table service restaurants in this country and roughly 18 percent of them are operating under a tip reporting agree-

ment. Clearly, the TRAC is not providing the appropriate exposure from an audit and assessment to entice the majority of restaurateurs to enter into a voluntary agreement.

I chose not to sign the agreement because, like many other restaurateurs, I do not like the idea of signing an agreement with the IRS. I do not like executing an agreement with an entity, like the IRS, which has no positive working relationship with our company, and an entity which has the high propensity to change personnel in who would be handling the relationship, thereby diminishing, or simply eliminating, all continuity of the relationship.

The employer obligations under that TRAC are significant. The requirements to educate employees and keep track of their tip reports, are in addition to the basic education and training an employer must engage in order for the employee to begin their job in the restaurant. This is particularly onerous for an industry that deals with a large population of young, transient and/or seasonal employees. National Restaurant Association research shows that the 27 percent of adults found their first job in the restaurant industry. A significant job-training responsibility, coupled with the additional educational duties required if you sign the TRAC.

For those that do sign the agreement, significant exposure remains. An important point that often gets misinterpreted by employers is that under the TRAC an employer is not protected from an audit and assessment, just an employer-only assessment. Additionally, the employer is not given retroactive protection. The protections of the TRAC only apply from the day it is signed forward. There have been inconsistent indications from IRS officials that the TRAC does apply backward beyond the date it is signed, yet no formal statements have been made to that point, and the wording of the TRAC belies the IRS' representation. Such a commitment would certainly be in line with the agency's objective of attracting more companies to the program, thus improving overall tip reporting.

The Association also believes it is important to note the TRAC program is set to expire at the end of 2005. There is concern within the industry that the IRS hasn't yet announced its intentions to extend the program, and that the recent Supreme Court ruling has provided a disincentive to do so. The uncertainty of the program's future creates further gaps of exposure. The Association would appreciate a commitment by the IRS that this program will continue as it helps the Association in advising their members on the success of the program.

In addition to these concerns, I can offer the following insights on behalf of the National Restaurant Association's larger restaurant companies:

Proper tip reporting by employees is a matter of great importance to larger restaurant chains, some of which have more than 1,000 restaurant units operating nationwide. These large employers are faced with the challenges and burdens of maintaining procedures and systems that facilitate and encourage tip reporting by employees; timely filing the requisite tax and information returns; educating employees; and collecting, depositing, and reporting billions of dollars in employment taxes, including FICA taxes.

For these reasons, large restaurant chains were among the first in 1995 to embrace the opportunity to work in partnership with the IRS through the newly issued TRAC program to increase the level of cash tip reporting by employees. Because of their commitment to and participation in TRAC, the program quickly became the model for how the IRS likes to partner with stakeholders to increase compliance with the tax laws of the United States. More importantly, the TRAC program has resulted in a significant increase in the reporting of cash tips by employees.

Nevertheless, following the Supreme Court's 2002 decision in *Fior D'Italia,* the industry has become increasingly concerned that the IRS may move away from its commitment to work cooperatively with large employers. A fundamental fact remains that restaurant employers are neither legally required nor factually able to guarantee that their employees will voluntarily report all cash tips received. Employers are concerned that good-faith compliance with the TRAC program, requirements may not ultimately protect against the threat of "employer-only" tip audits.

Significant concerns have arisen over the IRS's administration of the TRAC program. There are reports of uneven treatment of similarly situated employers at the hands of local IRS personnel. That is, employers that may have very similar educational programs and reporting procedures may be held to different standards by their local IRS employment tax specialists.

In some cases, IRS local teams have sought to hold large taxpayers to compliance and performance standards that are not set forth in the TRAC contract. For example, the IRS has argued that employers who have entered into a TRAC agreement must somehow ensure that directly tipped employees report "100 percent" of the cash tips they receive from customers. The IRS has also attacked the practice of employee "tip-outs"—where a server shares part of his or her cash tips with a bar-

tender or bus person—even though the TRAC agreement explicitly contemplate the sharing of tips. Moreover, the IRS has even asserted that the restaurant employer is not in compliance with the TRAC agreement if the tip-outs reported by servers do not reconcile with the tip-ins reported by the employees with whom the tips are shared, even though such reconciliation is not required by the TRAC contract, by the Internal Revenue Code, or by IRS regulations.

Many restaurant employers are fearful that the IRS has even predetermined a cash tip reporting percentage threshold that, if not met, will lead to threatened or actual revocation of the TRAC agreement. Such a position is not supported by the law or the TRAC contract. In fact, the TRAC agreement does not set forth any requisite level of "effectiveness" in terms of cash tip reporting percentage results. Indeed, the original working group of IRS and industry representatives that developed the TRAC framework considered—and rejected—an approach that would have required a restaurant's cash tip reporting percentage to be within a specified range of charged tip reporting.

Despite their good-faith efforts to comply with the TRAC requirements, many large restaurant chains live in fear of TRAC revocation and a subsequent employer-only audit. This state of uncertainty exists despite an IRS promise in 1999 that restaurant employers would not be held liable for employee non-reporting if they made good-faith efforts to follow the TRAC guidelines. IRS News Release IR–1999–84 stated:

> The IRS will no longer revoke TRAC agreements in cases where employers make a good-faith effort at following the guidelines but employees still fail to report tips. Instead of pursuing the employers in such situations, the IRS will focus on the employees who are not in compliance with tip reporting.

Notwithstanding this promise by the IRS, the NRA is not aware of any cases where the IRS has initiated audits of large chain restaurant *employees* where it may have observed low cash tip reporting by those workers.

The NRA is particularly concerned that the IRS may be revoking TRAC agreements without warning to or input from the affected restaurant employers. This places employers in a position of being procedurally defenseless prior to revocation, with no due process opportunity to address, contest, or cure any asserted breaches in contractual obligations. Moreover, an IRS decision to revoke without warning may actually result in revocation at the very time a restaurant employer's cash tip reporting percentages are improving dramatically—that is, when the cash tip reporting rate is moving in the right direction. TRAC revocation should be a last resort, a step taken where an employer is not working in good faith with the IRS.

Unless the TRAC program is properly administered, the NRA believes that the IRS will lose a valuable tool for fostering the intended cooperative environment that promotes employee tip reporting compliance over the long term. The TRAC agreement was intended to be method for employers and the IRS to resolve disputes before they arose. With proper administration, we believe the TRAC program can continue to be part of a systemic tip reporting solution. The industry stands ready to work with the IRS and Congress in that regard.

However, there are areas where progress appears to be at a stand still. First and foremost, I have to restate that the National Restaurant Association continues to believe that the IRS has gone beyond its authority in conducting employer-only audits and assessments. The Association believes employer-only audits and assessment create inaccurate and inflated assessments that employers are incapable of challenging. An employer has virtually no recourse when the IRS issues an aggregate assessment. How does the employer prove or disprove what an employee received in cash tips? In fact, another statement by the IRS' attorney during the oral arguments in the case *Fior d'Italia* before the Supreme Court, and there was audible laughter in the courtroom during the response of the government attorney when she acknowledged that an employer could obtain an employee's complete tip income records only by filing a lawsuit against the worker.

I can offer more personal insights on the newest of the tip reporting programs, the EmTRAC. The EmTRAC provides employers protection from employer-audits and assessments in return for employer commitment to employee tip reporting education efforts. The EmTRAC requires employers to design a tip reporting education program and submit that program for evaluation by the IRS. Unlike the TRAC, the EmTRAC allows for flexibility in the design and implementation of tip reporting education programs. The most significant difference between the two programs is that the TRAC requires employers to enter into a contractual agreement with the IRS. It is the contractual agreement aspect of the TRAC that has kept many restaurants from participating. The EmTRAC does *not* require signing a contract, only complying with the program created by the employer, as approved by the IRS.

The EmTRAC provides a more appealing option for my company, given the tip reporting initiative I developed known as K-Care. I did not create the K-Care program to protect my company from an audit; I did it *prior* to the IRS approving the EmTRAC approach and because at one point, K-Bob's staff turnover was more than double the average for the restaurant industry—230 percent! I realized we had to do something to change this pattern, not only for the sake of my company, but also for the image of the entire restaurant industry.

K-Care began out of the desire to more tangibly show hourly employees how much we care about them, how much they mean to the success of our business and how much we are willing to do to help them meet their career and financial goals. We assumed our employees knew we cared about them, but an employee survey surprised us by revealing that employees would recommend our restaurant for a meal but not for a job—only 33 percent felt the chain was interested in their welfare. We knew we had to create a more meaningful way to show we cared. And we thought the best way to do that was to invest in our employees. We decided to base K-CARE on reported tips, because tips are the easiest way to measure customer service in a table service restaurant. The harder you work, the more you earn. Good customer service is a team effort and K-CARE rewards all team members—from the host and the dish washer—to the server and the line cook.

Servers report their tips, and K-Bob's matches those amounts with a 5-percent contribution into a mutual fund: New England Financial's Growth Opportunities Fund. The more tips a server reports, the higher the matching amount. The mutual fund is split among all employees—front-and back-of-the-house—based on the hours they worked during any given quarter. Employees enroll at the beginning of a financial quarter and must be employed for the entire quarter to share in the earnings for that period. Employees can get access to their money once a year. They also receive paid vacation days, based on a formula that converts their reported tips into an hourly wage. Quarterly statements are mailed to employee's homes, just like a 401(k) statement. We also post the names of the top 10 earners on the restaurant bulletin board, to help other employees comprehend the long-term benefit of savings.

The results of the program are more than encouraging to K-Bob's management. What we found was that the K-CARE program not only gave employees more money, it improved tip reporting. Reported tips went up by 20 percent. In addition, staff turnover, which had been 230 percent, fell to 110 percent. Employees' attitudes toward the chain exceeded the goal. K-Bob's wanted to increase to 40 percent the number of employees who "totally agree" that the chain is concerned about their welfare. In the latest survey 61 percent answered that way. For K-CARE, the return on investment has been undeniable.

Consider the fact that the restaurant industry is the largest private sector employer in this country, and roughly 50 percent of our employees are under the age of 25. In fact, the restaurant industry is the first job for many of these individuals and I believe we can have a significant impact on their attitudes towards savings and investment if we can start educating them early.

Accompanying National Restaurant Association staff, I have met with the IRS to discuss the K-Care program along with the structural outline of a program submitted through the National Restaurant Association, as well as my concerns with signing a TRAC. I think it is fair to say that the concept of the K-Care program contributed to the creation of the EmTRAC—to encourage tip reporting initiatives, without the intimidation of a contractual agreement. At the time, I believed, based on this experience that my program would be one of the first to qualify under the EmTRAC, but as of today it has not been officially approved. Many restaurant companies have expressed interest in K-CARE and I believe we could be successful in marketing this program to a wider audience if the program were approved under the EmTRAC. I should also note that the K-Care program does not qualify as a 401(k). Contributions made by employers and employees are taxable. In order to get K-Care qualified, I would have to jump through numerous bureaucratic hoops. Based on my previous experience, the paperwork alone is extremely complicated and overwhelming.

I believe the EmTRAC could be a successful program and I hope the IRS can offer some insight on its use thus far by the restaurant industry. I would also recommend that the IRS do more to educate employers about its existence. I am sure the National Restaurant Association would help to distribute that information.

Mr. Chairman, I hope this extensive testimony provides useful insights and I thank you for the opportunity to present them to this honorable committee.

Chairman HOUGHTON. Thanks very much. Mr. Jablonski?

STATEMENT OF JOSEPH J. JABLONSKI, CHAIR, TAX AND FINANCE TASK FORCE, AMERICAN GAMING ASSOCIATION, AND EXECUTIVE DIRECTOR, TAXES, AZTAR CORPORATION, PHOENIX, ARIZONA

Mr. JABLONSKI. Thank you, Mr. Chairman. Good morning. My name is Joseph Jablonski. I am Executive Director, Taxes, of Aztar Corporation. Aztar is a casino gaming company headquartered in Phoenix. I am appearing today as Chair of the Tax and Finance Task Force of the American Gaming Association (AGA), the trade association of the commercial casino entertainment industry. Its members account for about two-thirds of commercial gaming revenue in the United States.

The AGA members employ a broad range of workers who receive tips from customers, including food and beverage workers, casino gaming staff, hotel bell staff, and parking valets. Tip-reporting in the gaming industry has taken a somewhat different path from the other industries you have heard about today. We use a tip compliance agreement negotiated between the industry and the IRS. I am here today to explain how it works, the benefits to both sides, and the lessons we have learned.

Under this approach, the employee agrees to report tips at a set rate specified for his or her job, shift, and location. These tips are included on the employee's W–2 along with the employee's regular wages. Taxes are then withheld on these tips and paid to the IRS. The employer agrees to take on the substantial administrative burden of implementing this new system. In exchange, the IRS agrees not to audit the employee or the employer on these tips for the current year or for prior years.

Once in place, a tip agreement benefits both sides. The IRS benefits from revenue collection and dramatically reduced enforcement and collection costs. The employee benefits from IRS audit protection, reduced recordkeeping, and then having a verifiable income helpful in getting auto loans, home mortgages, and Social Security and retirement benefits. The employer benefits from audit protection and some certainty. To get there, you have to reach an agreement with the IRS that is administratively workable and that uses reasonable tip rates. These are voluntary agreements. Both the employer and the employee must choose to participate. Hence, the agreement must be reasonable, benefit the employee and the employer as well as the IRS, and be built on cooperation. Insistence on capturing every dollar of income and indifference to the employer's administrative burden and its employee relations will make the employers and the employees alike reluctant to participate.

The key to the success of this voluntary program is reasonable tip rates for the employees. If the employee believes that the rate is fair and reasonable, he or she is more likely to sign on. The employer is in a delicate position here, standing between the IRS and its employees. The employees look to us to protect their interests, negotiating on their behalf with the IRS to try to get reasonable rates. The IRS has to be sensitive to this delicate dynamic. If the IRS seeks excessive tip rates, it not only discourages the employees from signing on, but it also chills relations between the workforce and the employer who is seen then as not advocating the employee interests with sufficient vigor. This undermines the employer's

credibility in encouraging its employees to consider signing on to this agreement.

The IRS also has to be sensitive to the administrative burden on the employer. The employer has to make a big investment of time, expense, and personnel to revamp its accounting, payroll, and computer systems to handle all of this, as well as to educate the employees. The employer also has to spend significant time working through tip rates with the IRS for its hundreds or sometimes thousands of employees. It is not feasible for the IRS to try to roll out the agreement all over the country at once. It really just bogs down the entire process. The gaming tip agreement has been successfully implemented in Nevada because we were able to negotiate reasonable tip rates with the IRS. We are hopeful for similar success in New Jersey if the IRS is willing to give the new agreement time to germinate. The IRS looks to expand the tip agreement approach across other gaming markets in other parts of the country, and potentially to other industries, success will depend upon a continuing recognition by the IRS that this is a voluntary program, both sides, in fact, must benefit, and there must be an administratively workable agreement with reasonable tip rates. Thank you for the opportunity to present these views on behalf of the AGA.

[The prepared statement of Mr. Jablonski follows:]

Statement of Joseph J. Jablonski, Executive Director, Taxes, Aztar Corporation, Phoenix, Arizona

Good morning, my name is Joseph J. Jablonski. I am Executive Director, Taxes of Aztar Corporation, headquartered in Phoenix, Arizona. Aztar Corporation, with approximately $1.3 billion in assets and 2003 revenues of well over $800 million, operates three casino hotels in major gaming markets in Nevada and New Jersey, as well as two riverboat casinos.

I am appearing today in my capacity as Chair of the Tax and Finance Task Force of the American Gaming Association (AGA). AGA is a nonprofit trade association that represents the commercial casino entertainment industry in addressing federal legislative and regulatory issues. AGA also serves as a clearinghouse for information, develops educational and advocacy programs, and provides industry leadership in addressing issues of public concern. AGA has 19 casino members which own or operate more than 150 gaming properties throughout the United States, accounting for approximately two-thirds of the country's commercial gaming revenue. AGA members employ a broad range of workers who receive tips from customers in the course of their employment, including food and beverage workers, casino gaming staff, hotel bell staff, and parking valets.

Overview of the Gaming Industry Tip Compliance Agreement

As others this morning have explained, the general rule of current tax law is that an employee who receives tips is required to regularly submit a report of his or her tips to the employer. The employer then withholds employment and income tax from the employee's wage and remits the employee's share along with the employer's share of the employment tax to the Internal Revenue Service (IRS) and reports such tips to the employee and the IRS on Form W–2.

Tip reporting in the gaming industry has taken a somewhat different path, beginning more than ten years ago with the negotiation of a tip compliance agreement in the major gaming market of Nevada. This original Nevada tip agreement worked well for the employer, the employee, and the IRS alike for a decade. The Nevada tip agreement expired at the end of 2002. AGA led the industry effort that negotiated with the IRS a new tip agreement, known as the "Gaming Industry Tip Compliance Agreement" issued by the IRS as part of Revenue Procedure 2003–35, 2003–1 C.B. 919. The new gaming tip agreement has been implemented in Nevada and most recently in New Jersey.

I am here today to explain how this tip compliance agreement works in the gaming industry and to discuss the benefits for the employer, employee, and the IRS,

as well as lessons we have learned in negotiating and implementing the tip agreement approach.

The essence of the gaming tip agreement approach is that, if the employer agrees to take on the administrative burden of implementing and operating the tip reporting system and the employee agrees to report tips at or above a rate that is determined with some specificity by occupational category, the IRS agrees not to audit the employee and the employer with respect to the tips.

More specifically, under this approach:

Employee Treatment

- The employee signs an agreement that he or she—
  - will report at or above the rate specified for the employee's particular occupational category, shift, and place worked;
  - can report below that rate if substantiated, but subject to possible IRS review; and
  - will file tax returns currently and for the prior 3 tax years.
- In exchange, the IRS agrees that it will not audit the employee's tip income for the current year as well as for prior years where no tip agreement was in place.

Employer Treatment

- The employer agrees to—
  - encourage employees to sign up;
  - withhold and pay the payroll taxes on the reported tips;
  - maintain certain records to compute future tip rates;
  - report annually to the IRS information on its tipped employees to enable the IRS to determine if they reported the appropriate amount of tips;
- In exchange, the IRS agrees that it will not audit the employer for tip-related payroll taxes (meaning that mass "employer-only" audits seeking to collect the employer's share of tax on some IRS collective estimate of alleged underreporting of tips by the employer's entire tipped workforce will not occur).
  - the IRS can still assess employer portion of payroll taxes on a non-participating employee if an actual audit of the employee first proves underreporting of tips by the employee.

Other Key Terms of the Agreement

- Agreement runs for 3 years.
- If business conditions change, rates can be redetermined by the employer and the IRS working together.
- If employee participation falls below 75%, the IRS can come in and discuss the reasons (likely that employees view the specified tip rates as too high and in need of readjustment).
- If participation falls below 50%, the IRS can terminate the agreement its discretion.
- The employer can terminate at any time.

Lessons Learned from Negotiation and Implementation of the Gaming Tip Agreement

- ***The tip agreement approach is not necessarily a "one-size-fits-all" approach across industries***

  In the gaming industry, the employer typically has a sizable number of tipped employees working at a particular facility, making the administrative burden of participating in a tip agreement at least viable. The same may not be true of various other industries in which there are a limited number of tipped employees located in a particular market or limited number of tipped employees scattered around the country in different markets.

- ***The agreement is voluntary—there must be inducement for both the employer and the employee to participate***

  A tip reporting agreement provides benefits to the IRS in the form of revenue collection and dramatically reduced IRS enforcement and collection costs and offers the *potential* of benefits to an industry and its employees in the form of certainty and a streamlined tip reporting system. However, whether those potential benefits to the industry and its employees are realized in a manner sufficient to warrant industry and employee participation depends upon the development of an administratively workable tip agreement that utilizes reasonable tip

rates. These are voluntary agreements in which both the employer and the employee must choose to participate, and hence the agreement must be reasonable.

By contrast, insistence on capturing every possible dollar of income and indifference to the employer's administrative burden and its employee relations will produce reluctance by employers and employees alike to participate in a voluntary tip agreement program.

- ***To gain employee participation, tip rates must be reasonable***

The tips rates are determined by the employer and the IRS, in consultation with employees and employee groups, from formulas developed in case law, information from the casino's records, observations of tips received, and discussions with employees. These rates are estimates of amounts received by a theoretical employee working in that occupational category, shift, and location in the employer's facility. The actual amount of tips received by an employee for a particular day or week may be more or less than the calculated tip rate and will fluctuate depending on the season of the year, the volumes of business, changes in the employer's business operations and staffing levels, and the level of service perceived by the customer.

In discussions with gaming industry employees during the recent negotiation of the new agreement, it is clear that their acceptance of a formal tip compliance program is fundamentally tied to the reasonableness of the tip rates. It has been the gaming industry's experience that so long as its employees believe the tip rates are reasonable, they are more likely to participate in a tip compliance program because it reduces their recordkeeping burden, gives them protection against IRS examination, and produces a verifiable income that is helpful in securing auto loans, home mortgages, and social security and retirement benefits.

By contrast, as the tip rate exceeds what the employee believes he or she has earned, the employees become increasingly vocal in opposition to the tip agreement approach and decline to participate in the first instance or drop out if they are participating. In negotiating the new tip agreement with the gaming industry for Nevada, the IRS proposed a drastic increase in tip rates in many cases, sometimes double or triple the tip rate currently being applied to the employee. It took several years of hard-fought negotiations by the industry with the IRS to reach a more reasonable level.

As the IRS looks to expand the gaming tip agreement beyond the Nevada and New Jersey markets currently covered to other gaming markets, it is important for the IRS to proffer reasonable rates to induce participation by the employees who are new to the tip agreement approach in these markets and are likely to view it with uncertainty and a certain wariness. Similarly, as these gaming tip agreements come up for renewal, it is crucial that the IRS also take a reasonable approach in renegotiating the tip rates, to maintain the success of employer and employee participation in these voluntary agreements.

- ***To gain employer acceptance, the administrative burden must be workable and the IRS must be sensitive to the delicate interplay between the employer and its workforce on this issue***

The tip agreement approach effectively requires the employer to serve as an intermediary between the IRS and the employee in the tip agreement process, a delicate position for the employer vis-&-vis its workforce. Accordingly, there must be a sense of mutuality of benefit and cooperation for the IRS and the employer under the agreement, to persuade employers to shoulder the added responsibility of participation.

While the employer realizes some administrative gains from simplification of the payroll information-gathering process using a consistent hourly rate for the position rather than obtaining tip information from each employee, the employer faces substantial new administrative burdens in implementing the new agreement. The employer must incur the cost and effort of significant systems changes in the tracking of time and attendance and its payroll system to implement the tip agreement approach. Changing the employer's systems is an extensive project involving wholesale revamping of existing accounting, payroll, and computer systems and creation of new systems, requiring significant efforts by the employer's staff in each of these administrative areas on top of their everyday duties in running the business. For example, we have spent well over a year developing and putting into place these administrative system changes at our Atlantic City facility to implement the recent New Jersey gaming tip agree-

ment. The employer is absorbing all of these costs. In addition, the IRS should be wary of heaping extensive new reporting and recordkeeping requirements on the employer under a tip agreement.

The employer's administrative burden of developing tip rates is also extensive, and only exacerbated if the IRS seeks to require frequent revisions. In this tip rate setting process under the gaming agreement, separate tip rates are developed for numerous job positions and outlet locations within the employer's facility for each shift, covering hundreds or thousands of tipped employees at each gaming property. For example, there are different tip rates for the parking valet on the graveyard shift, the bartender in the casino bar on the day shift, the cocktail server on the swing shift in the quarter slot area, the cocktail server in a high-end restaurant, to name only a few. Special considerations must be given to tips shared by wait staff with the busing staff. For employee relations reasons, care must be taken across the various positions and shifts so as not to upset the desirability of those positions because of tip rate disparities among employees receiving similar amounts of tips.

More fundamentally, the IRS must be sensitive to the delicate interplay between the employer and its workforce on this issue. The recent experience of the Nevada gaming agreement negotiation is that the employees look to the employer to protect their interests here—they view the employer as negotiating on their behalf with the IRS in an effort to achieve reasonable tip rates. If the IRS is seeking rates that the employees view as excessive, that not only will discourage employees from signing on, but also will chill relations between the workforce and the employer who is perceived as not advocating employee interests with sufficient vigor, thereby undermining the credibility of the employer in encouraging its employees to consider participation in the tip agreement.

In addition, the employee participation threshold required under the tip agreement should be set at a reasonable level, recognizing that gains to the fisc of bringing a significant percentage of the employer's workforce into the tax withholding system are far preferable to having no agreement at all, particularly in light of the fact that under the agreement the IRS will continue to have full enforcement and collection authority with respect to tip income of nonparticipants. Flexibility should be provided in the early stages in a new market to permit the ramping up of participation. The causes of drop-offs in participation should be explored in reasonable discussions between the IRS and the employer, rather than placing the employer in the role of "policeman" in a situation where it has little practical control.

- ***The tip agreement must provide flexibility to respond to significant changes in circumstances***

  In the immediate aftermath of the 9/11 attack, air travel plummeted and with it tourist visits to Las Vegas. Under the old Nevada gaming tip agreement, there was no adjustment mechanism for tip rates, and so employees continued to be taxed at the specified rates on tip income they were not in fact receiving. Local IRS officials, including Jack Cheskaty and Dennis Ozment, are to be commended for responding to this severe problem by granting temporary relief for the employees during the slowdown. One of the major selling points of the new gaming tip agreement to employees is the creation of a formal mechanism for adjustments in assumed tip income during economic slowdowns.

- ***IRS pursuit of tip agreements in an industry must take care to avoid upsetting competition in the market***

  Seeking to implement tip agreements on an employer-by-employer basis among competitors in a particular market can create competitive imbalances that are harmful to the employer. An employer which agrees to implement a tip agreement program may find its labor costs have now risen and its workforce recruitment hindered relative to a competitor down the street which does not operate under agreement. Accordingly, while tip rates must necessarily be tailored to the employer's particular circumstances and hence negotiated individually, the effective date of tip agreements must be uniform across competitors in a specific market.

- ***IRS efforts to expand a tip agreement nationally must not overextend the administrative resources of an employer operating in several different geographical markets***

As noted, the determination of tip rates is a very extensive administrative undertaking by the employer, requiring substantial time, expense, and commitment of personnel who have other business responsibilities, to revamp its systems and compute a broad range of tip rates. For an employer operating in several different geographical markets, many of the same personnel are involved in helping to determine the rates for each market. The IRS's eagerness to "roll out" the gaming tip agreement to different markets across the industry must be tempered by the recognition that overextending the employer's administrative resources and the same personnel will bog down the entire process.

- ***Once a new tip agreement is put in place, the IRS must exercise patience in letting it germinate***

Once a new tip agreement is negotiated and put into place, in practical terms the burden of implementing the new system and encouraging employees to sign up falls to the employer. There is an inevitable ramping up period for implementation in new markets with employees who have never seen such a thing before. Particularly in light of the dramatic reduction that the IRS realizes in collection and enforcement costs under the new system, the IRS must exercise patience in letting the new agreement germinate. For example, the gaming tip agreement approach was put into place in the new geographical market of New Jersey just a few months ago. With the ink barely dry on these new tip agreements, some IRS examinations staff already are pressing to audit compliance with the new agreements.

Conclusion

The Gaming Industry Tip Compliance Agreement, as issued in Revenue Procedure 2003 is fair and reasonable for both the industry and its employees and the IRS, subject to the negotiation of reasonable tip rates by the employer and the IRS. The Agreement has been successfully implemented in Nevada because the parties have been able to agree on reasonable tip rates. The industry and its employees are hopeful that similar success can be achieved in New Jersey. However, the IRS should allow a full calendar year of operation under the new agreement—particularly since it is being put into place in New Jersey for the first time ever—before attempting to evaluate the program's success or to invoke traditional audit tactics.

As the IRS looks to expand this tip agreement approach to gaming markets in other parts of the country—and potentially to other industries—the success of such efforts will hinge upon a continuing recognition by the IRS that this is a voluntary program in which there must be a mutuality of benefit for the employer and the employee as well as the IRS, requiring an administratively workable agreement that utilizes reasonable tip rates.

Thank you for the opportunity to present these views on behalf of the American Gaming Association.

Chairman HOUGHTON. Thank you, Mr. Jablonski. Mr. Zona?

STATEMENT OF FRANK ZONA, GOVERNMENT AFFAIRS CO-CHAIR, THE SALON ASSOCIATION, AND OWNER, ZONA SALONS, NORWELL, MASSACHUSETTS

Mr. ZONA. Thank you, Mr. Chairman, for holding this hearing. Thank you to Congresswoman Johnson and to all of you for introducing H.R. 2133. That is something that is very important to us. My name is Frank Zona. I own a salon in suburban Boston. I have 18 employees there, and I personally deal with tip income, so I will come at it from a point of view of being a voluntary government Affairs Chair for TSA, but also as someone who is living the issue. A lot of the things I hear on the panel are things that ring true to me.

The salon industry, when we talked about the idea of creating a supportive environment to help compliance increase and to help business and so forth, and I think it is important to know what the salon industry is first. It is not just hairdressing, although that is

a big part of it. You might want to think about it in terms of personal services. It is a big industry, multi-billion, a lot of people working in it, a lot of businesses working in it, so think of day spas and hair salons and barber shops and people doing skin care and it is growing. The personal service area is growing. We are still kind of an emerging industry if you look at it that way. It is becoming a little bit more formal, but it is still a lot of mom-and-pop. There is still a lot of confusion out there on issues such as tip income. We try to do our job as an association to educate, work with the IRS in a cosmetology TRAC, and so forth. I will come at it that way to try to bring you both perspectives.

Congresswoman Johnson's bill came about because there were salon owners in Connecticut who were struggling with the issue of tips and contacted her. We were just beginning to hear about it around the country, and her office contacted us and said, is this a wider problem and is there maybe some legislative solution? That is how we came at that. I would say it is about 5 years now dealing with the issue of tip income for us, so it is new to our industry relative to the others. The big difference is this: we have a split in the industry of employment where the people who work for us are W–2 employees, but many salons work as self-employment. If you think of this group of chairs here as a salon, if you are cutting hair, I might employ you and W–2. That is how I work. I also have the choice of just saying you can just rent that chair, give me $200 a week for renting the chair, and we have no employment. That is really the core of our problem with the whole issue of tip-reporting because I am under pressure to get my employees to report their tips. If they do not like it, they can very easily move. In the gaming industry, it is really hard to carry a roulette table down the street and plug it in somewhere else. It is hard in the restaurant industry to open a basement cafe. In our industry, if you have an employee who does not want to report their tips, or maybe does not even believe that tips are income—and that is something that truly, if you lined up 100 employees in our industry and said, "Are tips income?" most of them would say, "No, those are mine, those are a gift." So, we are still struggling at that real fundamental level.

The idea of creating the environment, we need to make sure that we do not see real significant labor shifts where people can, if they are going to report in one place, then they can just slide away and go somewhere else. That goes to the core of H.R. 2133, which what it would do is, on the one hand, provide the relief to the employer in the industry, extend the 45(b) tax credit that the restaurant industry has, and that is important because the costs of complying are significant. In addition to those costs, incidentally, something that jumped into my mind is credit cards. Credit card companies now in many cases, if you take tips on credit cards, charge an additional fee for it. I would say the employer cost is more than 7.65 percent. It might more approach 10 percent, what we hear from our members, administration costs and just tracking those tips, and so forth. Again, it is that alienation from your employees that you get that is the bigger issue. House Resolution 2133 would extend that 45(b), provide us some financial relief in that sense.

It would also introduce a little information reporting on that other half of our industry, and it is about a half-and-half split with

the self-employment and it would basically systemize that. If I am a salon owner who employs you folks, then I issue you a W–2 every year. If it is the other way around and I rent you those chairs, now I would issue you a 1099 with instructions on how to report your tips as a self-employed individual. It is not an absolute cure-all, but we think it is really reasonable, healthy legislation that would provide the kind of support in the industry to create that environment that we think will help tip compliance improve all around. The IRS has a good working relationship with them. We do owe them some thanks, I think, because hair color is a big part of our industry, and I do not think there is a Federal agency who has done more for the development of white hair than the IRS, and we very much appreciate that. Thank you for the hearing.

[The prepared statement of Mr. Zona follows:]

Statement of Frank Zona, Government Affairs Co-Chair, The Salon Association, and Owner, Zona Salons, Norwell, Massachusetts

Chairman Houghton and Members of the Committee, thank you for the opportunity to testify before you on behalf of The Salon Association (TSA).

My name is Frank Zona and I am a third generation salon owner from Norwell, Massachusetts where I employ 18 people. I currently sit as Co-Chairman of Government Affairs for The Salon Association. Primarily, we represent the small businesses of the salon industry, which is the great majority of the industry. In fact, 84 percent of salon establishments (with payroll employees) have fewer than 10 employees. It is also important to note that over 80% of salons and spas are owned and staffed by women. In 2002, the salon industry posted sales of $26.4 billion, with more than 750,000 employees industry-wide. There are far many more that work in the industry, but they do so in self-employment rather than employment-based situations; a fact that is central to our problem.

We support Representative Johnson's bill, H.R. 2133, The Cosmetology Tax Fairness and Compliance Act. This bill extends existing law to permit salon employers to claim the 45(b) tip tax credit that's currently available only to restaurant employers with tipped employees. The legislation also provides needed assistance to the federal government by improving tip reporting in all sectors of the industry. The legislation came about because salon owners from Connecticut contacted Representative Johnson about the problems associated with tip reporting, and her staff contacted TSA in an effort to see if the problem was widespread and if we would support a legislative solution. The answer to both questions was yes and we are thankful for her initiative. We are currently working with the International Chain Salon Association in supporting her bill on a national level.

The expanded credit is a matter of simple fairness and common sense. Like the restaurant industry, salon owners must collect and report tip information from its employees to the Internal Revenue Service (IRS), and pay FICA taxes on the reported tips. However, unlike the restaurant industry, salons cannot claim the tax credit for FICA taxes paid on tips. Given that our average wage is over $11.00 per hour before tips, it stands to reason that we deserve equal treatment.

The credit also serves as an offset to the significant costs related to complying with tip tax laws. We must educate employees about tip reporting laws, pursuade our employees to comply, keep records of reported tips, and report the income to the Internal Revenue Service. Credit card companies are in many cases charging extra fees for tip transactions. Therefore, although the salon employer is already paying over $11 per hour, he or she is facing a matching FICA liability equal to 7.65% of tips earned and the additional administrative costs. The actual full cost is closer to 10%. The extension of the 45(b) tax credit to salon owners will bring needed tax relief to help offset the costs of complying.

But the greatest compliance cost of all is being put in an adversarial position with your employees in an industry where employment isn't the only way to receive income. Worker classification is the issue that separates salons from other tipped industries. Unlike most tipped industries, a significant segment of the salon industry is classified as self-employed. While two salons may look the same, one may classify the people behind the chairs as employees while the other may classify its workers as self-employed (or independent contractors). The focus on tips in employment situations is encouraging employees to leave employment for self-employment, and leads employers to reclassify their workers as self-employed. Submitted with this testi-

mony is one example of a solicitation from a salon offering a "tax saving" chair rental opportunity (Attachment 1). The bottom line is that the tip-reporting burden is greatest on employers and compliance efforts need to be approached with these dynamics in mind.

If the IRS does not pay equal attention to both aspects of the salon industry, it will damage employment in the industry. If casino employees are getting pressured by their employer to report all of their tips, they cannot unplug their roulette tables and set up down the street. A waitress cannot just take her tables and open a basement cafe. But a hairdresser or massage therapist can easily find a less formal "self-employment" situation. Submitted with this testimony is an overview of the salon industry that indicates the size of the non-employed sector (Attachment 2). Self-employment is significant and growing. And leads to this point: Where employees do not want to comply with regulations, they can easily leave and rent a chair where there is no employer to withhold from them. The compliance portion of the legislation adds simple information reporting to salons that classify their workers as self-employed.

While it is possible that some individuals working in such a manner report all of their tips and income as self-employment income, it is well documented that the lack of third party reporting and withholding reduces compliance. There is no question that the greatest source of compliance is a paycheck subject to withholding. So what's at risk here for salons is not only the reporting of tips, but the loss of employees. What's at risk for the Treasury is not just the reporting of tips, but the reporting of income altogether.

These are not just statistics for me. I have lost 5 employees in the last 18 months who are now renting chairs in other local salons. Our insistence on complying with tip laws was a major factor in these employees' decisions to leave, and in their conversations with one another. It will continue to be a factor. And I can say that because I am present during the conversations where an employee claims that tips are not income but a gift, or that their accountant is taking care of it and it's not my business, or that they can just go rent a chair. Put yourselves in my shoes for a moment. You are competing with salons that are willing to pay under the table; willing to classify the people they work with every day as independent contractors; willing to turn their heads on tip reporting. So while you are responsible and concerned about paying your share of FICA on tips, you find yourself with problems that are more pressing than a potential audit—the loss of your people and the tax advantage of illegitimate competition. Doing the right thing should not put people at a disadvantage to those who do not.

Here are our suggestions:

1. **Congress needs to pass H.R. 2133.**

The provisions of H.R. 2133 are reasonable, have been scored favorably by the joint committee, have received the cosponsorship of 42 members of Congress, and have been worked on diligently for 4 years. It is the extension of existing law to an industry at a pivotal time when long-term overall compliance could go in either direction.

2. **The IRS needs to provide more information to the industry.**

Since trade associations play a critical role in disseminating information to the industry, it is critical to have statistical facts about IRS activities. Though the IRS has made significant efforts in outreach, TSA has experienced numerous IRS organizational changes that still leave us without consistent relationships and without critical information. Only in February 2004 did we learn that 1000 TRAC agreements had been signed. We know the IRS is working with the state boards, but we are not included in that dialogue. We are not provided any statistical information about the number of enforcement actions that are taking place in the non-employment sector. This is important information for the industry so that we can inform and advocate appropriately and effectively.

3. **The IRS needs to systemize contacts with the self-employed.**

It is the IRS's contact with the employers in the industry that has increased compliance in that segment. There is not an equal level of contact with the self-employed.

Salon owners and industry stakeholders from around the country tell us that while they increasingly hear about employer contacts and audits, they never hear about self-employment contacts or audits. TSA has not received any information from within the industry of any enforcement activity in the self-employed segment. We lack confidence that the IRS has a clear strategy to achieve equal treatment of both segments of the industry.

The compliance provision of H.R. 2133 would systemize taxpayer contacts by requiring that the correct form be issued to self-employed workers by the establishment. In a simple way, this third party action provides a point of contact for the IRS.

Additionally, the TRAC agreement should be modified to expand the role of the IRS in contacting departed employees. Existing TRAC language places a clear requirement for employers to notify the IRS of the departed employee and for the employer to provide departed employees with tax forms within 14 days of departure. The IRS should be required to follow this employer action with a contact.

4. **EmTRAC should be offered to the salon industry.**

Salons and spas each have their unique circumstances. EmTRAC allows employers who work with the IRS to develop a customized agreement to get the same protections the TRAC provides—i.e., protection from employer-first audits; but with a little more flexibility to develop tip-reporting procedures that better suit their needs. And while the IRS must approve an EmTRAC, it doesn't require an employer to enter into a formal written contract with the IRS.

5. **The IRS needs to connect the license with the tax filer.**

The most universal arm of government in the salon industry is the state board. It's the one place where everyone in the industry meets. Every individual needs a professional license before they begin practicing. Every salon needs a facility license before they can open. Licenses need to be classified according to taxpayer type. This would provide a cross-reference link for both the individual and the business.

6. **The IRS needs to develop industry specific guidelines for worker classification.**

The IRS should work with the industry to develop industry specific guidelines on worker classification. During a time of increased compliance activity on tips, the risk of worker misclassification becomes greater. No one wants to see a salon or spa flip its classification from employment to self-employment to avoid tax liability. We need industry specific classification criteria to reduce misclassification and increase compliance.

I thank you for this opportunity to share some ideas, and I'll leave you with these thoughts:

At the bottom of this problem are people who have no intention of complying; in the middle are people who want to do things right, but need a supportive environment; and then there are leaders. It is damaging to the industry and the IRS's long-term compliance efforts to work from the most compliant to the least compliant. Employers and their employees are the most compliant. Tax code and tax policy should reflect this in the ways indicated.

I look forward to working together toward a long-term solution and I welcome your questions and comments.

Thank you.

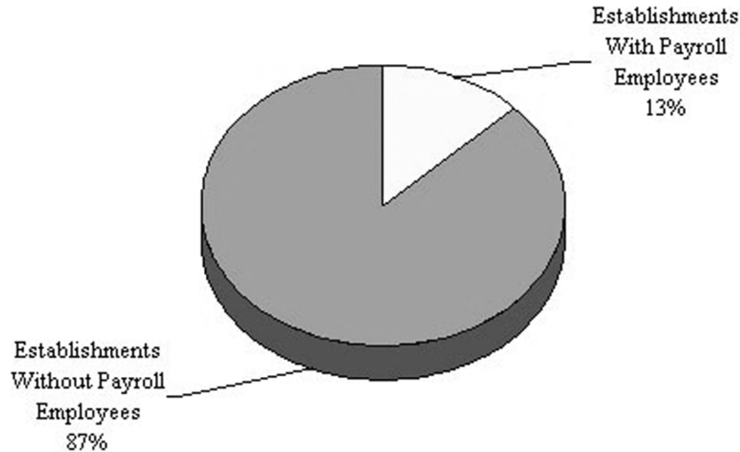
Salon Industry Facts July 2004

The Salon-Industry is a Collection of Small Businesses

- There are more than 655,000 Salon-Industry establishments in the United States, with annual sales of more than $26 billion. The Salon-Industry is primarily comprised of single-unit operations, with 98 percent of Salon-Industry firms having only one establishment.
- A large proportion of Salon-Industry establishments are small businesses, in terms of their annual sales volume. Fifty-one percent of Salon-Industry establishments (with payroll employees) have annual sales of less than $100,000, while 84 percent of establishments have annual sales of less than $250,000.
- The majority of Salon-Industry establishments are small businesses, as defined by the number of individuals that they employ. Eighty-four percent of Salon-Industry establishments have fewer than 10 employees.
- Eighty-seven percent of Salon-Industry establishments are non-employers, meaning they have no payroll employees. With the exception of unpaid family workers, individuals who work at non-employer establishments are classified as self-employed.

Distribution of Salon-Industry Establishments

Employers versus Non-employers



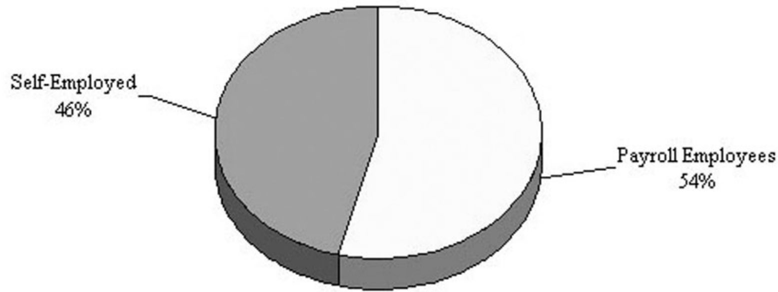
SOURCE: U.S. CENSUS BUREAU; 2001–2002 DATA

The Salon-Industry Employs a Large and Diverse Workforce

- The Salon-Industry employs more than 754,000 individuals in the United States.
- Eighty-four percent of Salon-Industry employees are women, compared to 47 percent of employees in the overall U.S. workforce.
- A diverse workforce is a hallmark of the Salon-Industry. Fourteen percent of Salon-Industry employees are African American, compared to a national average of 11 percent.
- Eleven percent of Salon-Industry employees are Asian, compared to just four percent of the overall U.S. workforce.
- Eleven percent of Salon-Industry employees are of Hispanic origin, slightly below the national average of 13 percent.
- The Salon-Industry is expected to continue to grow and provide employment opportunities well into the future. By 2012, the Salon-Industry is projected to provide employment for more than 865,000 individuals, an increase of 111,000 jobs (or 14.7 percent) above its 2002 level, according to projections by the Bureau of Labor Statistics.
- Forty-six percent of all individuals in the Salon-Industry are self-employed, according to the Bureau of Labor Statistics.

Distribution of Salon-Industry Employees

Payroll Employees versus Self-Employed



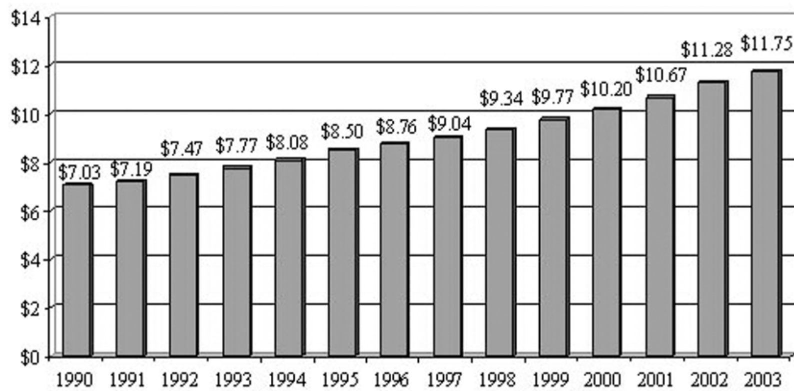
SOURCE: U.S. DEPARTMENT OF LABOR, BUREAU OF LABOR STATISTICS; 2002 DATA

Average Hourly Earnings of Salon-Industry Employees

- Non-supervisory employees in the Salon-Industry earned an average of $11.75 per hour in 2003, excluding tips. In comparison, non-supervisory employees in the overall private sector earned an average of $15.35 per hour in 2003.
- Since 1990, average hourly earnings of Salon-Industry employees have risen steadily. The average of $11.75 per hour earned by non-supervisory employees in the Salon-Industry in 2003 represented a strong 67 percent increase above the $7.03 earned in 1990. In comparison, the average hourly earnings of non-supervisory employees in the overall private sector increased at a lower 51 percent rate between 1990 and 2003.

Average Hourly Earnings (Excluding Tips) of Non-Supervisory Employees

Barber Shops, Beauty Salons, and Nail Salons



SOURCE: U.S. DEPARTMENT OF LABOR, BUREAU OF LABOR STATISTICS

NOTE: FIGURES INCLUDE ONLY ESTABLISHMENTS WITH PAYROLL EMPLOYEES

Chairman HOUGHTON. Careful on that.

[Laughter.]

Thank you very much. I would like to ask just a couple of questions, and, by the way, thank you very much, and then I will pass it along to Earl and then anybody else who wants to ask questions. I do not quite understand how the TRAC system can work for the little guy as well as the big guy. I understand the philosophy behind the program, and I understand how it works. Maybe you could help me on this, Mr. Rosic.

Mr. ROSIC. Certainly. The requirements of TRAC are very costly and require a substantial commitment, no matter what the size of the employer. Certainly we see that a small operation may find different challenges to overcome in some respects than a large chain. However, remember, even if there are, say, 900 food and beverage outlets throughout the country, each one of those is itself a small operation. The implementation of TRAC on the ground is going to be as difficult for a large chain as it is for a small operation. However, it may be that large employers are able to dedicate subject matter experts to establishing the right procedures and monitoring them than would be possible for a smaller operation.

Chairman HOUGHTON. If you run a small restaurant with four or five employees, and you are keeping the books, cash register, and everything else, is the TRAC possible under that?

Mr. ROSIC. Well, I guess providing training and education materials is as hard if you have 5 employees as if you have 500 employees. The devotion of resources to that effort is disproportionate for a small operation as you describe. The recordkeeping is probably similar, although a large employer is going to be able to invest in systems that make it more automated.

Chairman HOUGHTON. Well, I would like to ask another question, and anybody can answer this. You are really talking about those programs from the standpoint of the ownership, of the management. Other than wishing reporting programs would go away, what would your employees say if they knew there had to be some sort of a structure, regulation, and discipline? How would they organize these programs? What would they suggest to this panel if they were sitting in your place?

Mr. TINSLEY. Mr. Chairman, I think that is one of the challenges that I tried to allude to earlier. We are an industry of 12 million people, and we have so many people joining our workforce for the very first time in their careers. We are talking about some of the very basic educational commitments. There are so many challenges that small business operators face that it is hard to sum up what I would call priorities on how you address these. Employees, I think first of all, would want to see something that was to their benefit of why it was beneficial, and that starts with education. That is one of the things that we have seen in our industry, that if you can sit down and explain to them the benefits to their Social Security fund, to the fact that on their W–2 they are going to have higher reported income that they can go buy a house, buy a washer and dryer, do those things that are very basic when they are young that they need credit for, or buy a car. What I have seen is where you can have the time to do that, it is successful and you put some monetary incentives behind it. The challenges are, when

you are in our industry, is the turnover and the passing through aspect of it. It makes it a challenge. You see a lot of new faces that you are having to educate daily. It is a huge challenge.

Chairman HOUGHTON. I understand the importance of education and understanding how this fits into the overall scheme of things and the whole concept of taxation versus gifts. At the end of the day, what would the employee like to see? Does he want to see a straight rate recognizing that compliance is necessary?

Ms. POWER. If I may, Mr. Chairman, I think that the employee would want to have the flexibility to report exactly what he does earn. I think that the employee would be able to tell you many, many reasons for why the perceived rate, the charge tip rate is not the rate that he walked away with when he left the establishment at the end of the day. I do not think the employee would want to see a flat rate because I think that employees make tips at different levels, varying levels, and they tip out at different levels. I think that the employee would want to see a system that has the flexibility for them to report what they earn and no more, and for employees who receive less to not be penalized by reporting more than they earn.

Chairman HOUGHTON. If there is flexibility, no rules, under an honor system, and employees have to report tips, factor that into their income, and employee B does not do this at all, and that is just the way it goes. Is that right?

Ms. POWER. Well, there are significant rules in place to overcome that. The IRS has regulations that require employees to keep records of the tips that they receive. They are very, very detailed recordkeeping requirements. If it appears that an employee has not reported what he owed, then he is subject to proving that he received less than that.

Chairman HOUGHTON. Does anybody else have any other thoughts on this? How about a representative from the salon industry?

Mr. ZONA. Specific to our industry, one of the things that comes into mind—and, again, it goes to that dual way of working—is that I think employees feel good about being able to voluntarily report what they earn. That system works. They are very aware of, is the person next to them reporting, and next to them not just in the sense literally in that salon but throughout the industry. I think that the sense that, you know, I will pay, is everyone else paying, goes to our industry specifically.

Chairman HOUGHTON. So, if everybody else does not pay, then you want a different system. Is that right?

Mr. ZONA. Well, in our industry, if we have a salon down the street—and I have lost five people to tip income, 18 months, roughly, and we required tip-reporting. We have our own system. We are not under TRAC. They have got opportunities, you know, to just, again, go rent a chair. If they think that the rest of the industry is not reporting and they are somehow foolish for being part of a small business that counts, I think that becomes an issue. That would they want? I think they are okay with it, but I think they look around and it matters to them that there is an evenness to the whole thing.

Chairman HOUGHTON. Thank you very much. Mr. Pomeroy?

Mr. POMEROY. I have enjoyed the panel presentations very much. Thank you for excellent testimony and bringing your perspective to the Committee. For me, this is a new issue of inquiry, and so I do not know anything about all this. Help me along the learning curve, if you would. Starting with Ms. Power, it seems to me that this potential of aggregate liability is a significant incentive to employers to really engage with the IRS and work this seriously. Is it more or less the driver in terms of eliciting private-sector cooperation? Or is it a significant enforcement issue with repeated IRS activity in terms of bringing actions against the employers on this aggregate issue?

Ms. POWER. Well, I think that the figures bear out that the aggregate assessment was not essential to a significant, a very, very dramatic, a doubling of the amount of tip-reporting over the last—I think it was 8 years or so, because during that entire period, the IRS had a moratorium against employer-only assessments. Notwithstanding the fact that—and it was publicly—you know, highly publicized. Notwithstanding that moratorium, there was a dramatic and significant increase in tip-reporting during that period in time. I also think that there are many other reasons why the employer would facilitate, encourage, and promote the full and accurate reporting.

Mr. POMEROY. Absolutely. Absolutely. I am just trying to get a sense of the level of enforcement action we have on this aggregate business. Once the moratorium lapsed—and I know you are a lawyer, not a trade association. I am wondering if you have a sense in terms of what has been unleashed by the IRS in terms of actions under this aggregate.

Ms. POWER. That would be over, I believe, the last couple of years since the Supreme Court held that they had the authority to do this. I think that there have been maybe about 30, 40 audits on that basis since that period in time.

Mr. POMEROY. It is my sense not a lot.

Ms. POWER. No. That is correct, although that would be significantly more than the number of audits that they had in the early nineties when they started doing this. There were, I believe, less than that, maybe half that, in the early nineties.

Mr. POMEROY. Right, which is probably why tip-reporting income was so low, perhaps. I mean, there might be some linkages there. Thirty actions across the United States of America over the last 2 years, this is a highly reserved enforcement potential action, but one that is hardly bedeviling main street businesses as they do their operations.

Ms. POWER. Well, I think in large part, the reason why tip-reporting was so low throughout the eighties and even into the early nineties was that the IRS did nothing to educate the restaurant community and the employees about tip-reporting at all. Congress passed the tip allocation provisions, the 8-percent allocation rule, in 1982 and then the IRS did absolutely nothing with that for more than 10 years. Most employers thought and most employees thought and most IRS personnel thought that the only thing that employees had to report was 8 percent. It was news to a lot of companies that they were required to report any more. I think that the

increase has come from employer education of employees and from IRS education. They have made significant strides.

Mr. POMEROY. So, it does seem that there has been some significant achievement, both private and public, and a fairly good result there. Mr. Tinsley, I certainly appreciate your perspective as a restaurant owner, a restaurant chain owner, and then also on behalf of the association. In the end, you believe that if they are going to be trying to get down to finding how much tip income an individual has, it should be individually determined based on the employee. Is that correct?

Mr. TINSLEY. That is correct.

Mr. POMEROY. In principle, I understand that. Just as a matter of running a tax system, would that require individual employee audits to wrestle that down? Is that an impossible burden in terms of administering a nationwide tax system?

Mr. TINSLEY. No, I do not see it at all as an impossible burden. In fact, I feel like it is the primary line or first point that any IRS agent should go to, is the taxpayer, and establish what is the liability of the taxpayer if they have a question. To me it goes in concern with every other business in the country. I do not know of any other business where the IRS can go to the employer, to audit them first, before they go to the employee.

Mr. POMEROY. Well, though, there are some distinctions. I mean, basically tip revenue is in part direct compensation from the customer to the employee; whereas, in other businesses the employer provides 100 percent of the compensation. I think there is a pretty important difference. You are not taking a position of audit my employees?

Mr. TINSLEY. No. What I am suggesting is that if there is a question on the liability, the first line of questioning or establishment of what the tax liability should be should be with the employee. I think that is even more important than the distinction that you just drew because the employer has very little to no control over what the tip amount is.

Mr. POMEROY. It seems to me this Employer-designed TRAC (EmTRAC) is maybe a way to try and reach it—a way that has more or less a cooperative resolution.

Mr. TINSLEY. Absolutely.

Mr. POMEROY. How have you found your participation in it?

Mr. TINSLEY. It is excellent because actually we do it all from a company perspective. What we do is, it is re-emphasis of what we are doing, it is education, it is repetition. It is every payroll the tip rates come out and show what the unit is doing as a whole. It is the camaraderie. I will re-emphasize what Tracy was just alluding to. To me it is an educational and a marketing obligation, and I think that is the approach that the IRS should take in concert with our industry. When you start talking about aggregate assessments, I think that is where you cross the bridge from creating a working positive relationship to a threatening relationship. That is where you start getting destruction in the progress. I think that is where we are headed, especially with a lot of companies that have encountered those kind of threats.

Mr. POMEROY. It is kind of a carrot-and-stick deal, isn't it? On the carrot side, your participation in EmTRAC protects you from

certain liabilities that the IRS will bring against you, and for that the IRS receives your significant efforts in trying to make this all work better. On the other hand, you know, sometimes carrots and sticks work better than just carrots. Do you know anyone that has ever had an enforcement action under aggregate?

Mr. TINSLEY. Yes.

Mr. POMEROY. Do you?

Mr. TINSLEY. Yes, and I think the question becomes in the TRAC side—and I want to not paint the IRS as totally a bad organization, because it is not. I have had a great rapport with some individuals there. The challenge begins, Congressman, whenever you discuss these ideologies and the philosophies upstairs at 11th and Constitution, something is left between there and the field office in Albuquerque. We all face those challenges in our businesses, but I think the IRS may face even more of a substantial challenge. Not only their field people do not know and understand the TRAC or the EmTRAC, but they really do not have the same constructive—a lot of times—maybe a better way to say it is they have an inconsistent approach on that enforcement.

Mr. POMEROY. They tend to be cops, not partners. I got it. Thank you very much for superb testimony.

Chairman HOUGHTON. Mr. Herger?

Mr. HERGER. Thank you very much, Mr. Chairman, and, again, I want to thank each of you for appearing here today. My background is from a small business, and I think about the reasons why I ran it for as many of the concerns I am hearing from you. Even though we have a well-meaning government, it is not always what government is doing for you but what they seem to be doing to you that concerns you. I think that is what our responsibility as elected officials is, to try to be that buffer between the two, attempt to make the system work as it should.

I think, Mr. Tinsley, you probably mentioned some of the challenge we have. Once you get from the top here in Washington, to work its way down through—I am sure it is well-meaning but, nonetheless, this great bureaucracy, to where you get where the rubber meets the road, so to speak, is where our problem seems to lie. I would like to ask each of you, if I could, to respond briefly to this question: do you think the aggregate estimation method is a fair way to determine unreported cash tips? If not, why?

Mr. TINSLEY. I would be glad to address that, Congressman. Initially, absolutely not do I think it is fair. First of all, let's take the purpose of the Social Security or FICA tax is to be attributed directly to the employee for their retirement benefits. The aggregate assessment does not do that. It assesses the employer, and it is no way tracked back to the individual employee to attribute to their Social Security fund. That is one. The other thing is it is totally inaccurate in the fact that in aggregate assessments they take largely credit card tips, which are established at one rate, and assume that, one, no server has been stiffed, no walk-outs, no manager, no take-outs, no manager meals, no comps. They also assume that cash tips are going to be equivalent to credit card tips. That is just not the case. Those are two very important reasons why that does not work.

Mr. HERGER. Maybe the rest of our restaurant people, and then I have maybe a follow-up for you, Ms. Power. Mr. Rosic?

Mr. ROSIC. Thank you. I agree with Mr. Tinsley. I would add that it unduly shifts the burden of proof to the employer in any attempt to defend against an aggregate estimation method assessment rather than focusing on the taxpayer at issue, which is the employee. Everybody is potentially subject to audit, and the employer is not in this case failing to pay taxes that are shown to be due. It is the employee who has not reported the tips and the IRS has methods by which to get at that information, which is going to be more accurate if the recordkeeping has been done correctly by the taxpayer.

Mr. HERGER. So, it might be one thing for an employer to educate and try to inform as much as you can these employees, many of which are maybe in their first jobs or whatever, but it is something else to hold them responsible for taxes that really are not theirs. Mr. Jablonski?

Mr. JABLONSKI. Yes, I guess from a practical standpoint since we have sort of had to go through this whole process of negotiating actual tip rates with the IRS, from my perspective I would just like to echo that this is exactly what happens. What typically the IRS did—and I will speak to New Jersey because that was the last place we put one of these tip-reporting agreements in place. The IRS sort of makes a first pass. They take our sales data and hours worked type data, and they come up with tip rates based on some formulas that they have developed and that have been developed through court cases and then they bring those to us, and they propose these initial tip rates, and they say, okay, well, we think your cocktail server should make X dollars per hour.

Well, then, as employers, we go to the employees and the employees' management, and we say here is what the IRS proposed, now let's hear your side of the story. That is exactly where we get into things like stiff factors, and they talk about carry-outs or things that we are not even aware sort of in our ivory tower approach that, you know, the employees tell us about. Slowly but surely that tip rate gets whittled down to something more to the actual tip rate that is being earned. I would certainly say that, you know, this aggregate approach is the wrong way to go. The IRS really needs to go and look to the employees because, you know, they are the ones that are required to keep the tip records, and they know their story. They know the situation that is involved. I guess that is what I would have to offer on that?

Mr. HERGER. Mr. Zona?

Mr. ZONA. Too many variables, and it then does not go to the employees' individual funds. That does not feel right. Then it gets to a problem of educating, if you are educating people that you are supposed to report, and this is, you know, supposed to be how it goes, it does not feed that education process either. No, we are not in favor of the aggregate approach at all.

Mr. HERGER. Do you think it is fair and equitable?

Mr. ZONA. No.

Mr. HERGER. Okay. Thank you. Maybe just a very quick follow-up. Ms. Power, I want to thank you for representing my good friend and constituent, Bob Larive, before the Supreme Court on this very

issue. I would like to just hear your thoughts on what you believe is Congress's appropriate role in this matter given the Supreme Court's decision.

Ms. POWER. Well, first off, to comment and add to the comments that were added here, the only thing that I would add in terms of the fairness or unfairness of the aggregate method is that the potential cost is financially devastating, and it grows and grows and grows each year. I think the Supreme Court decision said, well, you know, all the employer has to do is put aside some money in a reserve for that. At this point, it is absurd that it continues to grow and grow and grow and nobody should have to operate their business under that type of threat.

As far as what I think Congress should do here, I really think that your bill is an excellent solution. I do not think that the aggregate estimate method is necessary. To respond to what the IRS' biggest complaint often is, it is that, well, otherwise, we would be forced to do employee audits. The restaurant industry provides the IRS more information than any other employer as to the earnings of their employees. Every single year on that Form 8027, the restaurateur identifies every single employee who receives less than 8 percent. The IRS can take that form, and if the IRS wants to, it can issue letters to those employees to collect the taxes on that amount. No long, timely audit is necessary to do that. The same information that the IRS uses to assess the employer, the IRS can turn around and do the same computation for individual employees.

Mr. HERGER. Ms. Power, thank you very much. I notice my time is up, but thank you very much, and I want to thank each of you for participating. Hopefully we will try to bring this to a more equitable solution and outcome. Thank you. Mr. Chairman, thank you very much for your generosity in time.

Chairman HOUGHTON. Thank you. I am trying to move this along, and we have a vote in about 10 minutes. If we could have the answers a little faster and a little briefer, I would appreciate it. Mr. Tanner? I said the answers.

[Laughter.]

Mr. TANNER. I will have to break a lifetime here of congressional rhetoric to be brief. I thank all of you for being here. I just have one short question. Some of you have indicated that the TRAC agreements work pretty well for you. I know we have figures on some salons have agreements and some do not. For any of you, is there an approach that Congress could take to either give more flexibility to the IRS or to do something to make these agreements more adaptable to the real-world situation that you describe? It looks to me like one of our problems is holding one entity liable for another's actions. That is very unusual in our system for an employer to be held responsible for the underreporting of someone else, the employees. That is not usually the way we view the law in this country. Is there something that you would suggest that we could do in this regard? The bell is ringing. Thank you very much.

Mr. TINSLEY. I do not think that giving the IRS more flexibility is the answer. I think holding the IRS to an accountability or a process is what is important due to the challenges that the IRS has from the ranks, from the Constitution down to the field offices, be-

cause we see a lot of inconsistent treatment. I believe there is only 18 percent of the restaurants that are subject to being eligible for TRAC are actually on TRAC. That tells me something is broken, and I think it has more to do with the education and understanding of how it all works and the fear or the threat factor than anything else.

Mr. ZONA. For the salon industry, the flexibility for the employer would be important, so not necessarily more flexibility for the IRS but the EmTRAC being extended to the salon industry is, you know, very appealing. Each business is unique in that way, and what Ed is doing with his business is interesting.

Mr. TANNER. Thank you. I guess I misspoke when I talked about flexibility. That was flexibility for both parties. When you say one, ordinarily you mean both. Thank you.

Chairman HOUGHTON. Thank you very much. Mr. Ryan?

Mr. RYAN. I will wait for the next panel.

Chairman HOUGHTON. Okay that is fine. Mr. Sandlin?

Mr. SANDLIN. Following your direction, Mr. Chairman, I will try to be brief. I think the questions are more accurately directed to the IRS. I would say I am in support of all the testimony given this morning by the witnesses we have had thus far, and I think it is important in many ways to note that I think we are missing the point. While there may be ways to negotiate reporting and tip rates and those sorts of things, I think it ignores the underlying problem. The employers and the employees are required under the law to report income—income that they actually earn and that they receive. I know there is a statute about the estimated income, and I am very familiar with all that. I have a problem with it when you are paying tax and the government is requiring employers and employees to report on estimates. I certainly would not want to be pooled—I would hate to be pooled with you, Mr. Chairman, and have to pay based on that. I just think that is wrong.

The industry is not the secret police of the IRS, and I think if the IRS thinks there is a problem, then the IRS needs to take care of their business and they need to do it in a way that is consistent with the Constitution and with the Fifth amendment, and maybe they should get a good book on privacy and read that. If we are going to target the restaurant industry and the salon industry and the gambling industry, then we need to target the doctors and the lawyers and the bankers and the candlestick makers, just like us. I was looking yesterday at some of the issues on the IRS. The taxpayers overpay taxes by an estimated $1 billion a year because they fail to claim an itemized deduction. A quarter of the taxpayers who are eligible for the earned income tax credit (EITC) fail to claim it because it is too complicated. Small business overpaid their taxes by $18 billion in 2000 and 2001 because of return errors. Tens of thousands of farmers paid an average of $500 too much in tax because they failed to take care of income averaging.

The Deputy Treasury Secretary told the Senate Finance Committee that the IRS walked away from more than 2 million delinquent tax accounts last year totaling $16.5 billion. The agency pursued just 18 percent of abusive tax shelters. Mr. Chairman, when the IRS takes care of those and when they go after those tax shelters and when they start going after the accounts that are delin-

quent, I think then we can look at the poor waiters and waitresses and salon owners and hairdressers, and we can look at trying to do something to collect their tax. Until such time as they take care of this stuff, I think it is absolutely ridiculous to go after single mothers with three children that are wait staff in a restaurant trying to pay their bills. I yield back the balance of my time.

Chairman HOUGHTON. Does anybody have any comments on that?

Mr. TINSLEY. Mr. Chairman, the only thing that I would like to add is on the question from the Congressman on the flexibility issue. A follow-up to that is I feel like the flexibility is so important in the restaurant industry from the owner-operator's side because of the variation in the types of businesses that we have. We know from geographic location to style of the restaurant, where there is casual dining, fine dining, we know what works best. We do need the flexibility to put our programs in, educate our employees.

Mr. SANDLIN. I think it is great to educate your employees, and I understand flexibility. The real truth is the law requires you to pay tax on income, income received, and that is just the bottom line. If the IRS thinks there is a problem and people are not paying tax on their earned income, then the IRS can darn well find out how to do it. Putting restaurant owners and gambling operators and salons in the position of being their police and ratting out and reporting on their employees is just absolutely ridiculous. It is ridiculous, and we do not do it in any other industries. If they say, well, we do not have quite the problem in other industries, well, I do not know what to tell them about that. They are the experts in collecting tax and making people report. At the end of the day, you have to say everyone in America, no matter what your job is, is responsible for reporting his or her income accurately, period. That is the law, and if people are breaking the law, then we need to find some way to take care of it. It is not by putting an added expense and burden on the employers or making them be the secret police for the IRS.

Chairman HOUGHTON. All right. Well, thank you very much. We certainly appreciate your wisdom and your thoughts. That is all for this panel, and when we come back, we are going to have three votes. Mr. Conlon, who is the Director of Reporting Compliance at the IRS, is going to be our next witness. Thank you very much.

[Recess.]

Well, ladies and gentlemen, if we could reconvene our Committee, we have had our three votes. I do not know when the next series will be, but we will go right ahead and I think we will be okay. I would like to introduce Mr. William Conlon, who is Director of Reporting Compliance at the IRS. Mr. Conlon, will you please start your testimony? We are delighted to have you here.

STATEMENT OF WILLIAM F. CONLON, DIRECTOR, REPORTING COMPLIANCE, INTERNAL REVENUE SERVICE

Mr. CONLON. Mr. Chairman, Ranking Member Pomeroy, distinguished Members of the Subcommittee, I appreciate the opportunity to appear before you to discuss some of the key issues of IRS enforcement of the reporting of tip income. A more complete statement of my remarks has been provided in written form. The law

requires all employees who receive tips to keep contemporaneous and accurate records of the tips received, to report the tips received to their employers in a written statement at least monthly, and to report those tips on their Federal income tax returns. As 1990, which is the latest tip study available, using 1984 data and the results of our compliance efforts, we estimated that restaurant employees were reporting less than 50 percent of their true tip income. This study showed that employees working at the then-existing 69,000 restaurants were underreporting tips by over $2 billion.

Chairman HOUGHTON. Could I interrupt a minute? I know this is unusual doing it, but what is the source of that information, estimating 50 percent.

Mr. CONLON. Again, sir, that would be based on the taxpayer compliance measurement data that we had, plus our own experience. Clearly that is an estimate, but we felt that that was fairly objective. I would have to go back into the archives, but we could certainly do that to justify it.

Chairman HOUGHTON. No, please proceed. I just did not know whether you had that on the tip of your tongue.

Mr. CONLON. Again, the study did show a fair degree of noncompliance. There are now over 255,000 food and beverage establishments in existence employing over 12 million workers. In addition, there are many businesses where tipping is the norm, such as those involving gaming, taxi cabs, limousine services, golf clubs, cosmetology, and others. Along with the study, the IRS considered its examination programs which created burdens on the employers, the employees, and the cost of significant compliance resources by the IRS. Accordingly, the IRS began to explore new methods to achieve voluntary compliance. Those efforts resulted in the IRS tip compliance initiative. The initiative emphasizes voluntary agreements between establishments and the IRS regarding the reporting of tip income. While more detail is provided in my written comments, I would like to offer a few comments.

Our initiative emphasizes education of employers as well as their employees, simplification of the reporting process, and reducing burden by minimizing the possibility of a tip examination. While the initiative applies to all industries where tipping is customary, differing products have been developed to address specific needs. The Tip Rate Determination Agreement applies to—or actually models examination procedures to determine tip rates to be reported based on past experience. A review of employer books and records is required. For TRAC agreements, while no specific tip rate is determined, the employer institutes its own program or actions to bring itself and its employees into compliance. A limited review of records is normally performed. For the EmTRAC agreements, the opportunity is provided an employer to have their currently existing procedures reviewed by the IRS and accepted as meeting the requirements of the TRAC process. Finally, the Gaming Industry Tip Compliance Agreement is very similar to the Tip Rate Determination Agreement, but modified to meet situations unique to the gaming industry.

Tip income voluntarily reported from all industries on employment tax Forms 941 has increased from $8.5 billion in 1994 to $18 billion in 2003. While a range of factors has contributed to this, I

believe a significant portion of this increase reflects the presence of the IRS in the tipping industries, either through our education efforts, voluntary agreement programs, or enforcement activities. Within the tipping industries, there has been much discussion of the opinion of the Supreme Court which affirmed the ability of the IRS to use an aggregate estimation method for determining an employee's tip income and assessing the employer for its share of taxes due. Effective tax administration occasionally requires the IRS to use reasonable estimates when a precise determination is not practical. The Court's opinion confirmed the reasonable use of the authority granted to the IRS.

We believe that employers decide to participate in a tip agreement primarily because of the authority granted to the IRS to take appropriate enforcement actions when needed and the audit protection these agreements provide. The IRS does not have the resources to individually audit the many thousands of tipped employees who may not report all of their tip income. We must take a balanced approach which fully leverages education front-end voluntary agreements as well as enforcement efforts. Collectively, this will achieve compliance in the most efficient manner. We recognize that consideration has been given to possibly restricting the enforcement authority currently available to the IRS. In keeping with my previous comments, I would urge the Committee to work with the Treasury Department regarding any changes to current law.

We also understand consideration is being given to extending the application of the section 45B income tax credit. I would like to point out that a critical component of that credit for the IRS is the companion requirement to file a Form 8027. The IRS uses this form to assess the accuracy of income reporting in those industries. Tax administration could be difficult or costly if additional applications of the credit did not also include a means for efficiently determining its accuracy. Mr. Chairman, thank you again for allowing me to testify. I would be happy to entertain any questions.

[The prepared statement of Mr. Conlon follows:]

Statement of William F. Conlon, Director, Reporting Compliance, Internal Revenue Service

Good morning Mr. Chairman, Ranking Member Pomeroy, and distinguished Members of the Subcommittee. I appreciate the opportunity to appear before you this morning to discuss the issue of IRS enforcement of the reporting of tip income.

Improving the compliance behavior among tipped employees continues to be a focus of IRS employment tax initiatives.

The law requires all employees who receive tips (1) to keep contemporaneous and accurate records of the tips received, (2) to report the tips received to their employers in a written statement at least monthly, and (3) to report those tips on their federal income tax returns.

Employers are required to withhold income tax, social security or railroad retirement tax, and Medicare tax on the tips employees report to them in a written statement. The Internal Revenue Code provides that the employer is responsible for deducting and depositing the employee's FICA and federal income tax on tips included in the written report furnished by the employee to the extent that collections can be made from the employee's wages (under the employer's control, excluding tips) on or after the time the written statement is furnished.

Under section 3121(q) of the Code, tips received by an employee are remuneration for employment. The remuneration is deemed to be paid when the tips are reported to the employer by the employeepursuant to section 6053(a). If the employee failed to report tips, in determining the employer's FICA tax liability, the remuneration is deemed to be paid when notice and demand for the taxes is made to the employer by the Secretary.

As of 1990[1] (latest tip study available), using 1984 data, we estimated that restaurant employees were reporting less than 50% of their true tip income. This study showed that employees working at the existing 69,000 restaurants were under-reporting tips by over $2 billion. There are now over 255,000 food and beverage establishments in existence, employing over 12 million workers. In addition, there are many businesses where tipping is the norm, such as gaming establishments, taxi cabs, limousine services, golf clubs, cosmetology and barbering establishments, nail salons, health and beauty spas, tour guide establishments, cruise ships, and many more.

In the past, the IRS performed resource intensive examinations on the returns of tipped employees and determined that the vast majority of these employees were not properly reporting their tips. Significant tax assessments were being made against those employees being examined. The results of these examinations created significant financial burdens on the employees and the employer. They were also an inefficient approach to this compliance problem for the IRS. Accordingly, the IRS began to explore new methods to achieve voluntary compliance and, at the same time, reduce the burden for employees and employers. These efforts resulted in the IRS tip compliance initiative, the *Tip Rate Determination and Education Program* (the Tip Program).

Tip Rate Determination and Education Program (TRD/EP)

The IRS initiated the Tip Program in 1993 to improve and ensure tax compliance by employers whose employees receive tip income. The program was originally offered to the food and beverage industry, and subsequently to the Cosmetology and Barber and gaming industries. In December, 2000, we further extended this program to all other industries where tipping is customary.

The IRS initiated the Tip Program for various reasons, including:

- Education—To help tipped employees and their employers improve their understanding of the laws regarding the federal tax treatment of tips and enhance tax compliance through the use of advance voluntary compliance agreements,
- Simplification—To make it easier for tipped employees to calculate their tips, report their tips, and pay their taxes, and
- Burden Reduction—To reduce the likelihood of a tip examination and ease the financial burdens associated with a tip examination.

The program offers employers options to help employees more accurately report their tip income. These options include:

- Tip Rate Determination Agreement (TRDA)
- Tip Reporting Alternative Commitment(TRAC)
- Employer Designed TRAC Agreement (EmTRAC)
- Gaming Industry Tip Compliance Agreement (GITCA)

Other employers that can now participate in either a TRAC or TRDA include taxicab and limousine companies, airport skycap companies, car wash operations, tour guide companies, and many more.

Taxpayers in the food and beverage industry expressed interest in designing their own TRAC program. Notice 2000–21, 2000–19 I.R.B. 967, set forth proposed requirements and procedures for obtaining approval of an employer-designed EmTRAC.

The GITCA retains many of the features of the TRDA. However, since it is now offered through a revenue procedure, it now has the enforceability tool and safe harbor provisions that the industry requested.

The Tip Program is totally voluntary. An employer can choose not to enter into the program but, instead, institute its own program or actions to bring itself and its employees into compliance.

TRDA (Tip Rate Determination Agreement)

TRDA requires the business to work with the IRS to arrive at a tip rate for the various occupations within the restaurant.

Participating employees report tips to their employer at or above the rate determined in the agreement. However, if the employee actually receives tips below the determined rate, the employee is then required to report only the actual tips received. If an employee fails to report at or above the determined rate, the employer will provide the IRS with that information and the IRS may audit that employee's tax return. Employers and employees then pay the appropriate taxes on this income,

[1] Tip Income Study, IRS Research Division Publication 1530 (8–90)

including social security and Medicare taxes (FICA) and income taxes. The following requirements apply to TRDAs:

- At least 75% of tipped employees must sign a participation agreement with the employer.
- The tip rates are determined using financial and operating information available to the employer, historical information provided by the IRS, and generally accepted accounting principles.
- The TRDA does not have any specific education requirement but IRS provides assistance to help employees understand their tax responsibilities and emphasizes benefits for complying.
- TRDA is available for all industries where tipping is customary. TRDA is available to those businesses that operate primarily with cash receipts.

TRAC (Tip Reporting Alternative Commitment)

The food and beverage industry wanted to participate with the IRS to develop an alternative to TRDA to improve the compliance of their tipped employees. A coalition of both large and small food and beverage industry representatives worked together with the IRS to create the TRAC agreement.

TRAC requires employers to:

- Establish a reasonable procedure for accurate tip reporting by all tipped employees,
- Institute a training program to educate employees of their tax reporting obligations as they relate to tips, and
- Comply with all federal tax requirements regarding the filing of returns, paying and making tax deposits, and maintaining required records.

TRAC was originally offered only to the food and beverage industry but has now been extended to all industries where tipping is customary. A specific TRAC agreement is available for the Cosmetology and Barbering Industry. This agreement has characteristics unique to this industry.

The IRS will only terminate a TRAC agreement if the employer fails to meet one of the three commitments noted above.

EmTRAC (Employer Designed TRAC agreement)

The EmTRAC retains many of the provisions of the TRAC agreement. Employers commit to:

- Establish a reasonable procedure for accurate tip reporting by all tipped employees,
- Institute a training program to educate employees of their tax reporting obligations as they relate to tips, and
- Comply with all federal tax requirements regarding the filing of returns, paying and making tax deposits, and maintaining required records.

The EmTRAC program provides an employer with considerable latitude in designing its educational program and tip reporting procedures. Restaurant and bar owners must apply to have the IRS approve their program. Once approved, these employers will receive the same benefits and protections as afforded under the IRS administered TRAC agreement. The IRS has approved all seven EmTRAC applications received.

Gaming Industry Tip Compliance Agreement

The new Gaming Industry Tip Compliance Agreement (GITCA), while still voluntary, is offered through Revenue Procedure 2003–35. The agreement allows a gaming industry employer, its employees, and the IRS to work together to determine tip rates for specified occupational categories. The agreement prescribes a threshold level of participation by the employer's employees, and reduces the compliance burden for the employer and enforcement burdens for the IRS.

The Gaming agreement was originally offered through a Gaming TRDA. The new agreement, offered through Revenue Procedure 2003–35, was created in direct response to concerns raised by representatives from the Gaming Industry. As a result of these concerns, the IRS in joint cooperation with representatives from this industry, created the new agreement.

Indian Tribal Gaming

The Office of Indian Tribal Governments, under the Tax Exempt and Governmental Entities Operating Division (TEGE), serves as the coordinating office for all

federal tax administration needs with Indian tribal governments, which includes tax administration in connection with Indian tribal gaming.

There are 566 federally recognized tribes across the country. There are 310 gaming facilities within these tribal units, approximately 65% of which have occupations where significant tipping occurs. The remaining 35% consist principally of bingo or video lottery terminals, and do not lend themselves to having tipped employees.

Between entities where agreements are in place, and entities where compliance actions are currently underway, tip reporting compliance is being addressed with nearly 90% of the applicable customer base. We expect to reach 100% within the next 12–18 months, and will then focus primarily on maintaining compliance in the tip reporting area.

Level of Compliance

Various indicators show that voluntary compliance has significantly increased in industries where a tip agreement has been implemented.

IRS has secured 15,759 tip agreements that cover 46,596 establishments, as follows: (Indian Tribal agreements discussed earlier)

- 1,176 Restaurant TRDA agreements, covering 1,440 establishments [2]
- 12,871 Restaurant TRACs, covering 37,788 establishments.
- 2 Cosmetology TRDA agreements, covering 2 establishments
- 1,388 Cosmetology TRAC agreements, covering 5,470 establishments
- 322 gaming tip agreements, representing 1,896 establishments.
- 12 TRAC agreements with a transportation employer that represents 12 establishments.

Since the Tip Program was introduced, tip wage reporting from all industries on Forms 941 *Employer's Quarterly Federal Tax Return* has increased substantially. In 1995, tip wages voluntarily reported from all industries were $9.45 billion. They exceeded $18 billion for 2003.

Correspondence Examinations

To make this program successful, it must be balanced with enforcement activity. Industry representatives have voiced approval of the Tip Program but stated that the IRS needs to focus enforcement efforts more on the tipped employee and not solely on the employer.[3]

The IRS does perform examinations of those employees who do not agree to become participating employees and report their tips at or above the established tip rate.

The Wage and Investment (W&I) Campus in Fresno processes the Form 1040 examinations for employees identified to have unreported tip income. Over 5,000 tipped employees' returns were examined this year.

Section 3414 of the IRS Restructuring and Reform Act of 1998

Section 3414 of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998, prohibits the threat of an audit to coerce taxpayers into signing a Tip Reporting Alternative Commitment (TRAC) Agreement.

Section 4.23.7.4 of the Internal Revenue Manual (IRM) outlines procedures for soliciting tip agreements. The IRM prohibits the use of, or implication of, a threat of an audit to secure participation in any voluntary tip agreement. Examiners must provide the necessary educational material to any employer seeking information on the Tip Program whether or not a tip agreement is secured.

To avoid any implication of a threat of audit, the IRM requires an interval of at least six months between the last contact to solicit a tip agreement and when an examination letter is sent to the taxpayer. The six-month policy applies only to tip examinations and not to general income tax examinations that may warrant an audit under normal examination procedures.

United States vs. Fior d'Italia, Inc.

On June 17, 2002, the Supreme Court rendered a decision in favor of the Internal Revenue Service, in the case of *United States v. Fior d'Italia*.[4] The Supreme Court affirmed that the IRS has the authority to assess an employer's share of FICA taxes due on employees' tip income using an aggregate estimation method.

[2] A Restaurant TRDA is generally with a single-property Employer.

[3] Comments received during Restaurant and Bar Industry Meeting held April 2, 2003 at the Treasury Executive Institute in Washington, DC.

[4] U.S. v. Fior D'Italia, Inc., 536 U.S. 238 (2002)

In essence, the Supreme Court case reaffirmed IRS authority to assess employer FICA taxes on unreported tip income without having to audit individual employees. Employer-only FICA tax assessments are implemented only where other methods would not be appropriate.

Participation in a tip agreement is motivated primarily because of the audit protection these agreements provide and the employer-only authority that the Supreme Court case grants the IRS. Simply stated, the IRS does not have the resources to audit the thousands of tipped employees that do not report all their tip income. Reversal of the *Fior d'Italia* case would require the IRS to do tens of thousands of individual examinations in order to maintain the current compliance levels.

The following shows our audit activity for the past three years:

	FY 01	FY 02	FY 03	FY 04 (Estimated)
Employer Audits	239	126	113	228
Employee Audits	2553	1746	1420	5262

Section 45B Credit

Certain food or beverage establishments may claim an income tax credit under Section 45B of the Code for social security and Medicare taxes paid or incurred by them on a portion of their employees' tips. The credit is available for establishments whose employees received tips from customers for providing, delivering, or serving food or beverages for consumption if tipping was customary. The credit applies only to tips received by food and beverage employees.

Employers use Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips,* to claim the credit. The credit is available without regard to whether the tips were reported to the employer pursuant to IRC 6053(a). Thus, it is available for employer FICA tax paid pursuant to an IRC 3121(q) assessment.

The credit applies to employer FICA tax on tips received in excess of the tips "deemed paid" by the employer for purposes of satisfying the minimum wage provisions of the Fair Labor Standards Act (FLSA).

The credit is part of the general business tax credit. Because it is an income tax credit, claimed on the income tax return, it may be used to offset any income tax liability, but not employment tax liabilities. The income tax deduction for FICA taxes must be reduced by the amount of this credit.

Form 8027 *Employer's Annual Information Return of Tip Income and Allocated Tips* is an information return that employers who operate a large food or beverage establishment must file with the IRS. There are certain criteria for filing this return, as explained below:

- Food and beverage is provided for consumption on the premises;
- Tipping is a customary practice; and
- More than 10 employees, who work more than 80 hours, were normally employed on a typical business day during the preceding calendar year.

If the employer owns more than one establishment, generally, a Form 8027 must be filed for each establishment. Restaurants where tipping is not customary, such as cafeteria and fast food restaurants, are not required to file a Form 8027.

Total tips reported on Forms 8027 increased by more than $2 billion dollars between 1993 and 1996. In 2002, total tips reported on filed Forms 8027 were $8.89 billion.

We recognize that the food and beverage industry has expressed the concern that the law, in its present form, has created an inequity in industries where tipping is customary. The IRS has developed a program to establish tip agreements with businesses in the casino and cosmetology industries (includes barbering and nail salons) and agreements to encompass all other tipping industries.

We understand that the cosmetology industry is supporting legislation extending the 45B credit to their industry. At present, when monitoring compliance in the food and beverage industry with the requirements for the 45B credit, the Service uses information from the Form 8027. Under current law, comparable information would not be available for businesses in the cosmetology industry as they are not required to file Form 8027 or any other form containing specific information on charged tips.

In a study prepared by the Office of Research entitled, "The Effect of Tip Compliance Efforts on Tip Reporting," participants in the TRD/EP program reported charge and cash tips at a higher rate than non-participants.

Conclusion

Mr. Chairman, thank you again for allowing me to testify. I will be happy to entertain any questions.

Chairman HOUGHTON. Thank you very much. I just have a brief question, and then I will turn it over to the rest of the panel, particularly Mr. POMEROY. I am searching for what is the fair and practical approach. You obviously have improved the IRS regulations and the education system and the simplification, in terms of doubling the amount of revenue over the last—what is it, 10 years? Is that right?

Mr. CONLON. Yes, sir.

Chairman HOUGHTON. So, as you look to the next 10 years, do you continue on that program or do you not? The TRAC program is set to expire at the end of 2005. Do you want to renew that? What are your views on this?

Mr. CONLON. Mr. Chairman, we have had no discussions about stopping the TRAC program. Frankly, based on the comments and the sensitivity around that, I think it would probably be appropriate for the IRS to issue a notice and publicly go on record that we intend to continue to pursue that program in the future and remove any doubt or concern that there may be about that. In the gaming tip agreements that we initiated about a year ago and are currently signing, actually there is no back-end cessation of those agreements. What there is is a 3-year period, and we envision that every 3 years we should come in, have a session, determine whether the rates are still appropriate; and if they are, continue with the agreement in place; and if they are not, make any appropriate adjustments.

We have had progress over the last 10 years. The battle is not won yet, but I think we still have a high degree of noncompliance. I believe personally that voluntary agreements are the methodology that we are going to need to use to be able to get to a much higher level of compliance than we currently have. Everything that it takes to support that is, I believe, necessary. Behavior of taxpayers being what it is, if there is no compliance presence, I believe we would find it difficult to get people to come forward to sign voluntary agreements with us.

Chairman HOUGHTON. We have always had problems with the IRS, particularly in evaluating its budget, and determining if we have enough agents enforcing the laws. The whole tax system is based on trust and understanding and the belief that there is fairness. If some people are cheating and others are not, it really undermines the system. Let me ask just one final question. Is there evidence of a better solution to increasing tip-reporting compliance? For example, are any States involved in different approaches? Are there any foreign countries such as in England or in Germany? What programs are used in Japan? Is there any information which could help you think through what you are going to be doing in the next 10 years?

Mr. CONLON. Well, Mr. Chairman, I do not know that there is an easy answer to that one. The biggest hurdle that we have in the tipped income arena is that really the responsibility rests on the

employee to track their income and to report that to the employer. That is almost unique. Most of us have a responsibility to an organization or other responsibilities that are required to keep books and records and accurately report that as well. We usually have some checks and balances. A tipped income individual does not have perhaps all of the checks that other wage earners would have in other arenas, and it makes it much harder for us. I do believe that we can achieve additional compliance. I am not sure that there is an easy answer to that. I do not believe that it would be tolerable or advisable for us to institute mass volumes of individual examinations. I believe certainly we need to do some. We need to do some employer examinations in order to have a reasonable presence out there.

Chairman HOUGHTON. All right, thank you. Mr. Pomeroy?

Mr. POMEROY. During my question period, I did not get to the cosmetology industry, so let me start there with you. If I heard right, they do not have the EmTRAC opportunity, do they? What are the distinctions between the IRS handling of tip income relative to that industry versus the restaurant industry?

Mr. CONLON. The TRAC forum is a vehicle that we could use for the cosmetology industry as well, so there is no reason why we cannot move into that arena. We have had a number of discussions about having additional discussions with them. From a practical standpoint, we started with the population of tipped employees that we believed was the largest, which was the food and beverage industry.

Mr. POMEROY. Right.

Mr. CONLON. We are trying to move into other arenas, such as gaming and cosmetology. What we have found, I believe, is that as we go into it industry-by-industry, there are nuances that we need to consider because the essence of a voluntary agreement is that it must be reasonable for the employer, the employee, as well as the U.S. Government. All three of those interests need to be considered. It would not surprise me that we need to make further modifications or adjustments in order to have a vehicle which is appropriate for cosmetology.

Mr. POMEROY. Discussions have been described to me as proceeding in a constructive way toward this end. Do you envision administrative action in this area within the near future?

Mr. CONLON. Well, I do, Congressman, and I believe that would model the discussions we have had with the restaurant association as well as with the gaming gssociation. It is, realistically, resources which have kept us from doing that up until now. As we have had additional progress in those areas, I do believe we have the capability to now move forward.

Mr. POMEROY. Great. Now, the effect of H.R. 2133 that would bring to the salon industry the 45B non-refundable income tax credit for employer-paid Social Security taxes, can you describe what that is about?

Mr. CONLON. Well, what it would do is offer to those employers the same credit that is in food and beverage, which is to the extent that they pay a wage—not tips but wages—which exceed whatever is the stated minimum tax, they have the ability to get a refund for the employer portion of their FICA taxes.

Mr. POMEROY. Does the IRS have a position on that legislation?

Mr. CONLON. Sir, to my knowledge, you would really need to address that with the Treasury Department, since I see that more as a policy decision than an administrative one.

Mr. POMEROY. In terms of underlying circumstances, the circumstances within the restaurant industry that created the rationale to have that law probably also exists in fairly similar fashion, albeit in a different industry context, in the cosmetology industry?

Mr. CONLON. I would not have any argument with your statement. Again, I believe Treasury, though, would be the best organization to perhaps comment on that.

Mr. POMEROY. All right. There is a lot of concern in the enforcement area, as evidenced by the prior panel, on this aggregate responsibility and the potential exposure toward the IRS by individual employers. How do you see the IRS using its potential enforcement actions under that authority against individual enterprises?

Mr. CONLON. Well, the authority that we are resting on is not unlike other situations in administering the Income Tax Code, where if you get into a situation where the appropriate books and records have not been kept, we are left with trying to reconstruct the appropriate amount of income. In the absence of books and records, we will perform estimates using the information that is available. To the extent that we have—I mean, the more information we have, the better our estimates are going to be. I think some of the representations that we take charge sales and end there are far and away overly simplistic. That is merely a starting point. Actually, the many adjustments they have talked about in terms of stiff rates, tip pooling that may be taking place, whereas a waiter may take a portion of their tips and that may go on to the bus staff or even the cooks, all of those are factors that we try to take into account when we are preparing our estimates. Again, it is the absence of books and records which are requiring us to do a reconstruction and doing it to the best of our ability. I think in the final analysis, when you look at our estimates, for the most part they are deemed to be reasonable. Certainly there are a number of healthy discussions that we have with the employer or employee, but there are actually very few situations where someone has taken our proposed assessments and gone to, you know, a legal front and have it be found that those estimates were unreasonable.

Mr. POMEROY. In the prior panel—and I know I am out of time, but I think you can respond to this, perhaps with the Chairman's leave—30 actions brought over the last 2 years. Is the enforcement piece of the EmTRAC relationship between the IRS and the employer, in your view, basically to be a rarely used enforcement authority triggered where there is particularly egregious conduct that has merited this kind of IRS response?

Mr. CONLON. Well, actually, we have clear guidance to the field that would indicate that this should be a rarely used tool and it should be the last option that an examiner would avail themselves of. There are actually no situations where the IRS has gone back to 1988 to compute, you know, what may be deemed an excessive FICA tax adjustment. Our internal guidance is that normally one would not go past 2 years and then go forward. Of course, those

determinations are up to the field. There could be situations where they do a current-year assessment and go forward, all of that based on facts and circumstances. We certainly do not have a policy of exercising perhaps all the latitude that in theory is there by the Code, and we have clear parameters which would equate those adjustments to other income tax type decisions we are making.

Mr. POMEROY. Thank you.

Chairman HOUGHTON. Mr. Herger?

Mr. HERGER. Thank you. Director Conlon, I want to thank you for being with us here today. As you may know, I introduced legislation in 2002 in response to the concerns of restaurant owners following the Supreme Court case. Let me be clear that the intent of my legislation is not to stop the IRS from collecting FICA taxes on unreported tip income. The intent of the legislation is to make sure that the system is fair to restaurant owners and that unreported tip income is determined in the most accurate way possible. I want to ensure that restaurant owners are not put in the untenable position of being the tip police. This is not the small business man's or businesswoman's job. Their job is to run their businesses in the best way that they can. It is the IRS' job to enforce our tax laws. We need to be fostering a spirit of cooperation between tip businesses and the IRS. My concern is that the aggregate assessments undermine this spirit of cooperation.

My question is this: what is the IRS doing to make sure that your determination of unreported tip income is more accurate? How can a restaurant owner have confidence that if he follows the law and educates his employees, he will not be subject to an aggregate assessment on the estimated amount of unreported income over which he has no control? Remember, restaurant owners can only report to the IRS the cash tips that are reported to them by their employees.

Mr. CONLON. Well, Congressman, I believe that we have a system in place certainly that if the appropriate amount of tax is being paid, any estimation method we would take would confirm the accuracy of what has been reported, and there would be no additional assessment. The difficult situation, again, is when we have pockets of noncompliance, what is practical and reasonable for the IRS in terms of achieving the compliance that we are all seeking. An estimation allows us to have a platform by which we can work with the employer. We can also take that estimate and work with the employees to get compliance with them. Even if I had an individual examination, I would probably still find it necessary to go into those employer books and records in order to come up with an estimate of an accurate tip rate. It is a challenging situation, but, again, we do not use estimations to overturn books and records which are otherwise kept by the employer or the employee. We only use it when we have instances of the records actually not being maintained as appropriate.

Mr. HERGER. Mr. Conlon, were you able to—I believe you were present when our panel was here, and you heard some of the horror stories that come about. During the time when I was going to school, as is the case with many, worked in restaurants, and I know that there are employees, those that are working there, some of which may receive literally double—I know of cases of that—the

tips that maybe the rest of them would. I mean, you just do not know. Likewise, there are some who struggle and receive less than what they do.

The difficulty of coming up with these estimates—and I am sure you heard some of the testimony of the difference. There are carry-outs and take-outs and all the different little nuances that are there. Again, for these employers to somehow be held responsible for this—I know years ago now, I am a small business man myself, and I remember looking at some of the stats. At one time I actually considered going in the restaurant business until I looked at some of the stats. All small businesses are tough to make it when you start, but it is probably three or four or five times more difficult for a restaurant. You look at those, I think at one time, for every 15 restaurants that started every year, there is only 1 or 2 left after 3 years. I mean, this is a tough business to begin with for so many of them that are going. Do you have a response on how you can be working with this to correct this horrible dilemma that we are in?

Mr. CONLON. Well, that is a tremendously challenging question and an opportunity you have provided me, Congressman. Unfortunately, I do not know that I have a great answer for that. It is a difficult situation. The real challenge for the IRS is do you walk away from a known situation of noncompliance or do you try to take some reasonable efforts to deal with the noncompliance that is there. We are taking approaches that I think are reasonable. I do not think it is appropriate for us to walk away from this, or else we are abridging the commitment that we have to those taxpayers who are paying their appropriate share.

We stand ready to meet and work with any industry or group who has suggestions or methods for a better process than what we have got now. I think we have demonstrated that in the past, and we certainly stand ready to do that currently. If there is a better approach, we would be glad to have some substantive discussions and work to come up with a better product or a better methodology. To be honest with you, short of the current efforts we have, that represents our best thinking or certainly my best thinking at this point in time.

Mr. HERGER. I know my time is up, and the Chairman has been very generous. Just very briefly, and it may not even need a response here. Another concern, even some of these agreements that they come up with on a TRAC agreement, there is this concern of new people in with the IRS and the fact that the rules seem to be changing in this. Anyway, there needs to be something done where the restaurants have some sense of peace of mind working with the IRS. That is not there now.

Mr. CONLON. Congressman, if I could respond to that, if an organization has a signed agreement by an executive in the IRS, we live up to not only the words but the spirit of that agreement. I think our track record is that if you have it from us in writing, we do everything we can to meet our commitments. There are actually very, very few situations of us ever taking the effort to revoking an agreement. Out of over 46,000 voluntary agreements out there, we have 17 revocations, and this is going over all the records that I could find going back 10 years. That is an extreme situation, and

I think based on that history, I would hope that a reasonable person could look at that track record and understand that if they enter into an agreement with us, we are certainly going to meet our portion of the commitment.

Mr. HERGER. Thank you very much, Mr. Conlon. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you, Mr. Herger. Mr. Sandlin?

Mr. SANDLIN. Thank you, Mr. Chairman, and thank you, Mr. Conlon, for coming today. You indicated that you have a dilemma, and I would submit to you that you do not have much of a dilemma. Your position that the IRS is taking is much like you see in the movies when they find someone they think committed a crime, and the policeman says, "Go out and round up the usual suspects." That is what you guys are doing. You are going out and you are rounding up the usual suspects. You say that you have data within an industry that indicates a certain percentage of people are not properly reporting their income. That is not the way that this country works.

You have absolutely no information as you go forward except data, internal data from the IRS, and just because there is an internal average—or there is an average in an industry based upon your internal records, it does not mean a particular person has committed any crime. I do not think you have a dilemma. You have got a law that you enforce that says when people earn income, they receive it, they report it, and they pay their tax on it. Aren't employees required to pay income tax only on the income that they receive?

Mr. CONLON. Congressman, that is entirely correct. They are only required to report what they receive and no more.

Mr. SANDLIN. Right, and I do not have to pay tax on some sort of income average that I did not receive, right?

Mr. CONLON. That is absolutely correct.

Mr. SANDLIN. Okay. You said that you do not have enough resources to audit everyone, so we need a balanced approach, correct.

Mr. CONLON. Yes, sir.

Mr. SANDLIN. Now, failure to pay income tax is a crime, isn't it? Isn't that a crime if you do not pay your income tax?

Mr. CONLON. My wording around that is they failed to meet their obligations under the law. Whether that meets the definition of a crime, actually I do not know that that word is defined in the Tax Code as such.

Mr. SANDLIN. Oh, so the IRS' position is that if someone does not pay their income tax it is not a crime?

Mr. CONLON. I am saying——

Mr. SANDLIN. We need to get this to the bar immediately.

Mr. CONLON. Congressman, to my knowledge, the word "crime" is not defined in the Internal Revenue Code, and we do not use it internally to describe——

Mr. SANDLIN. Well, I am pleased to know that. Do you think that our constitutional rights require this balance that you are talking about, or do you think the Fifth amendment requires a constitutional—a balance of some sort?

Mr. CONLON. Congressman, I would actually be glad to have that discussion, but I believe now you are into a policy rule, which

is better handled by my colleagues in the Treasury. Again, my role is to administer the laws which are significantly or importantly passed by this body, and to the extent that I can, that is what I am attempting to do.

Mr. SANDLIN. Okay. That is a good answer to some other question. Do you think that as we round up these suspects, for example, that we should go to a bar and, as everyone comes out, we should round them all up and maybe give them Breathalyzer tests or charge them with public intoxication just because there is a whole lot of them in there and we figure they have been drinking? Do you think that would be a good position for the government?

Mr. CONLON. Congressman, I appreciate your comments; however, they do not describe the process——

Mr. SANDLIN. I did not ask you about——

Mr. CONLON. The policy and the procedures——

Mr. SANDLIN. What they described. You are the one that told us that you all are going after these industries because you think a certain percentage of the people are not paying their tax, correct? Just because a certain percentage are not paying does not mean that any individual is not paying. Isn't that correct?

Mr. CONLON. I do not know how you could reasonably assume that if—if we have a high degree of noncompliance, some individuals, some entities are not meeting their obligation——

Mr. SANDLIN. Exactly my point, and so you are rounding up the innocents with the guilty, and you are saying you are all guilty by association, and we are going to come in here and take care of you as the government because we just do not—we do not have the assets or the information or the money to protect your constitutional rights, so we are just going to all round you up. Let me ask you some other things that you all are so interested in helping people with these voluntary agreements. As I mentioned earlier, I had found yesterday some information that taxpayers overpay their taxes by $1 billion a year because they fail to claim itemized deductions. Now, do you all have a group that you work with to get some voluntary agreements to pay that money back to them? I mean, since you found that out, do you have some voluntary agreements that they sign and you say we are going to give back that $1 billion?

Mr. CONLON. Well, Congressman, we do have programs to better educate the public both on——

Mr. SANDLIN. No, I did not ask you about your education programs. What I said, do you get them to enter into voluntary agreements from the government, from the IRS, to give them back the $1 billion that you know you got illegally? I guess if it is illegal for them to not report, it is illegal for you to take it, isn't it? That wouldn't not be right? I mean, what is good for the goose is good for the gander, isn't it? Now, let me ask you about the quarter of the taxpayers who are eligible for the EITC that do not claim it because it is too complicated. Do you go back to them and have voluntary agreements on that? If you would like to come up and testify, sir, we would like to have you forward. You can come up and I will ask you some questions. Or how about the small businesses that overpaid their taxes by $18 billion? Do you have written agreements with them, voluntary agreements that say we are going

to pay back this $18 billion, we feel really bad about it? You do not have that.

This entire thing, Mr. Chairman, just scares me in that we have the government running around creating potential conflicts between employers and employees and going after people on criminal allegations when they have absolutely no information and no probable cause about the individuals involved, and you think you are going to strong-arm industries and poor waitresses, single waitresses with children. You do not even go and collect this money that you know is owed. You do not go and investigate abusive tax shelters. You do not give money back that you collect illegally. I think we are going about it the wrong way. When you take care of those things, then I think we can go look at our waitresses and folks that work in the gambling industry and otherwise. It is outrageous that the U.S. Government would go after people on criminal allegations without any sort of information whatsoever except data on a group. I am out of time.

Chairman HOUGHTON. I am not in Mr. Conlon's position, but I think the theme of this hearing is that everybody in his or her own way should be a part of the tax system, and we are trying to make it fair. Let me pick up on this a minute. It seems that you have got an almost impossible job, and I will tell you why I say this, and you can comment on this. It is that you are taking really low-wage earners, and many of them are making minimum wage. It is a wage which is not possible to live on, and they get a few extra dollars as far as tips. Essentially they have that, yet at the same time they are exposed the way the rest of us are, proportionately to their income on paying their tax. You can see this particularly in the lack of signing up with taxis and valets and bellhops and skycaps. They do not comply, or they do not sign up with any of your programs. I mean, if I was one of those operators, I think I would probably do something like EmTRAC where I could sort of design my own system, but they do not do it. Is it something which we can talk about and try to adjust, tweak the system a little bit? Is this something really which is fixable?

Mr. CONLON. Well, Mr. Chairman, there are actually, I thought, a couple questions there, and let me try to be responsive to that. I think from an administrative decision, what you really need to ask yourself is: do you put all of your attention to one program or do you try to have balance in tax administration? I think clearly we are trying to have balance, with the understanding that if you ever completely move away from a noncompliant segment, the situation is going to get rampantly worse rather than better.

From my standpoint, I have seen us take a number of aggressive steps to deal with tax shelters and abusive promotions, not only the promoters but the individuals who participate in those. Again, I believe our approach, which is to not put all of our resources in there, is appropriate, though clearly you do need to focus on major areas of significant noncompliance. Again, in that abusive arena, I believe we have done so and will continue to do so. In terms of a better approach, clearly we have had the approach in the past of let's just audit people until we get to compliance. I think our recognition is that that is not a winning solution for us; that is not the most efficient use of our resources. In light of that, we are now

trying to use all of the resources available to us, which certainly include education, voluntary agreements with organizations, and trying to move the ball forward using that type of an approach.

Again, I think the combination of the education, the voluntary agreements, and compliance or enforcement efforts is the methodology that we need to be using, and we just need to be careful that we are not outweighing one of those. It needs to be on a front that takes advantage of all those tools. Certainly it is not easy, but I do not think you would be expecting us to move away from this arena just because it is difficult for us to pursue it.

Chairman HOUGHTON. Well, let me try to put in my own words—and correct me if I am wrong—what I hear. The program should be voluntary; it should be flexible; it should not put the burden on the employer. It should help the employees; it should set up common procedures and education and understanding of the law and the authority and simplification and things like that. Occasional auditing, focus on the important areas, and just leave it at that. Tell me where I am wrong here.

Mr. CONLON. Mr. Chairman, I would not say you are wrong. I would say we need to and we do make continual assessments as to where we have the best application of our resources. The situation could change, and we could decide in the future to apply more to this program than we have in the past in light of significant noncompliance, again, in the abusive arena. I think that needs to be a clear focus area for us. We need to make sure that we are devoting the resources that we have available to meet those needs. Then we need to look at the breadth of noncompliance that we face, and that is a constantly challenging situation. Certainly different people can have different thoughts as to, you know, what is best in that arena. Clearly, that balanced approach, keeping in mind those significant egregious situations, is the approach that we have taken as an organization.

Chairman HOUGHTON. Okay. Mr. Pomeroy?

Mr. POMEROY. One of the presenters this morning made the observation that they felt this whole partnership concept, as kicked around down at the IRS headquarters, may get lost in terms of field implementation. I can certainly understand the management challenge of trying to basically hold the concept consistent through an operation spread all across the country with thousands of employees, although that seems to me a fair evaluation. Do you make efforts to try and have your personnel administer these TRAC agreements in the cooperative spirit that you have spoken to today?

Mr. CONLON. Congressman, I believe whether we are talking the tip income program or a general examination program, our thrust is always to be up front regarding what the issues are before us and try to work in a collaborative manner. That is the methodology that I believe we deploy in every situation. Certainly we have tools that if people do not choose to work with us in that manner, we can make those available and deploy those as needed. We need to give people an opportunity to comply at a reasonable cost, at a reasonable burden to them. We need to facilitate that process. Unfortunately, I believe we need to continue to have an enforcement presence that reminds people of their obligations and commitments.

Mr. POMEROY. Is the segment of our economy that involves tip income growing?

Mr. CONLON. Well, industry data that we have available would indicate that it has. Some of the numbers available to us from the Restaurant Association talking about 10 million waiters and waitresses; the cosmetology industry has published over a million members of the salon industry; I think gaming has an estimated 370,000 employees. There are other industries for which we do not have industry data by which to come up with an estimate. If you look at those numbers over time, I think you will see growth there. That is why I believe the noncompliance that we do have is something that we need to pay attention to, so hopefully we are growing more compliance rather than growing more noncompliance.

Mr. POMEROY. Thank you. I yield back.

Chairman HOUGHTON. Mr. Herger, do you have a question?

Mr. HERGER. Thank you. Mr. Conlon, just how effective do you feel that your TRAC program has been in improving compliance? Are there specific areas that you feel need improvement?

Mr. CONLON. Well, in terms of the clear impact that has had on compliance, actually I do not have information that would allow me to come to you and say because we have a certain number of TRAC agreements, compliance has improved by an indicated percentage. The TRAC agreement is something we came to in collaboration with the Restaurant Association. It was a vehicle that they thought was more appropriate for them, and it does seem on an ongoing basis to be getting us to a more compliant environment. When we have those agreements, my belief is we are significantly more compliant than those establishments that we do not have them with. Again, I do not have empirical data necessarily by which I could tell you that it is, you know, more compliant by a stated percentage.

Mr. HERGER. Thank you. Thank you, Mr. Chairman.

Chairman HOUGHTON. Mr. Sandlin?

Mr. SANDLIN. Thank you, Mr. Chairman. Just a few questions. You indicated and the Chairman asked about some opportunities to tweak the system. Now, as we mentioned earlier, an employee is required to report his received income, correct?

Mr. CONLON. Yes, that is correct.

Mr. SANDLIN. Then he is required to pay tax on that income, correct?

Mr. CONLON. Yes.

Mr. SANDLIN. So, that is tweak the system. I mean, that is the system, and that is what you need, and that is what the law is. I am continually concerned about your balanced approach as it tramples on the rights of individuals. You know, our government is not set up to take care of the whole. It is to protect the individuals. You said that, well, you do not think that the Congress would want you to move away because it is difficult to pursue this topic, correct?

Mr. CONLON. My understanding is that the balanced approach is what we are being expected to deploy, and that is the approach we are taking.

Mr. SANDLIN. My question was: you said that you think that the Congress does not want you to move away from this area just because it is difficult to pursue it.

Mr. CONLON. That is correct.

Mr. SANDLIN. My statement is to you that is exactly what I want you to do if by "difficult to pursue" you mean protecting the rights of the citizens. You know, our individual rights are protected in this country because they are difficult to take away. We do not condemn people and condemn industries and condemn individuals because they are in a certain group or class.

Now, my position is this: if you as the IRS have an individual that you think is not complying, you should by all means go after that individual. However, just because it is difficult to go after the individual or it is costly or you do not have enough staff or you do not have enough clerks, or whatever the problem may be—I understand that is a practical problem for you, but you do not get to go after people just because you have some pie-in-the-sky belief or hope that they are not reporting something. This balanced approach is the most—that is the most dangerous attitude I have ever heard from any government agency, that we are going to take a balanced approach. We do not take balanced approaches with the law. We all have individual rights that are protected absolutely, and when we start balancing them, you have to be a little bit concerned about who is doing the balancing and who is weighing that.

You said that people have to have an opportunity to comply in a reasonable way, and you need an enforcement presence that encourages people to comply. Most people understand, don't you think, that if they do not report the income, they can either be charged with a crime or required to pay back taxes plus penalty and interest? They understand there is an enforcement part of the IRS, don't you think?

Mr. CONLON. Yes, sir, I do.

Mr. SANDLIN. People have an opportunity to comply by reporting their income and paying their taxes, right?

Mr. CONLON. They do.

Mr. SANDLIN. It seems to me that you already have those opportunities, and certainly I think that the IRS—I know that you are challenged with your budget and what you need and the growing population and problems. I hope you will take into account the fact that we just cannot turn into a government or a government agency that tracks down people without specific allegations on the individual. Mr. Chairman, I think the entire approach is improper, if not unconstitutional, and maybe we should look at making sure they have enough assets to track down the money that is owed. Going after entire groups is pretty repugnant to the law. I yield back the balance of my time.

Chairman HOUGHTON. Well, listen, I thank you very much. You have got a tough job. You have been an excellent witness. I would like to work with you. I think we are always going to be facing issues because the margin of the income is so small. We have some Members who were not here, so without objection, we will allow Members to submit questions to be answered in writing. Without further ado, Mr. Conlon, thank you very much for being here. The hearing is adjourned.

Mr. CONLON. Mr. Chairman, Congressmen, thank you for your time. I appreciate it.

[Whereupon, at 12:47 p.m., the hearing was adjourned.]

[Submission for the record follows:]

Statement of Richard J. Walsh, Darden Restaurants, Inc., Orlando, Florida

I am writing on behalf of Darden Restaurants, Inc. ("Darden") to comment on the enforcement of tip reporting by the Internal Revenue Service ("IRS" or "Service"), which was the subject of the Subcommittee on Oversight's hearing of July 15, 2004. Included within the scope of the Subcommittee's review is the progress of the Service's Tip Reporting Alternative Commitment ("TRAC") program, which was officially launched in 1995. Darden, which was the first taxpayer to sign a TRAC Agreement, is writing to reconfirm its commitment to that partnership with the Service, but also to express concern about reports that the Service may not be honoring the terms of the TRAC agreement.

A. **Background.**

Darden is headquartered in Orlando, Florida and is the largest casual dining restaurant company in the world. We operate more than 1,300 Red Lobster, Olive Garden, Bahama Breeze, Smokey Bones BBQ and Seasons 52 restaurants in North America. We are leaders in each of our market segments and employ more than 140,000 employees. Consequently, the accurate reporting of tips is of great concern to us.

The numerous discussions between the IRS and the food service industry—which ultimately led to the launch of the TRAC Program in 1995—actually began with a small, informal meeting in March 1994. Ernie Harper and I of General Mills Restaurants, Inc. (now Darden), Tim Halverson of Charthouse Restaurants, and a representative of Hyatt Hotels met with Tom Burger (then the Director of the IRS Office of Employment Tax Administration and Compliance), Bob Cossey (an IRS Revenue Officer from the Phoenix District), and Tony Warcholak (an IRS Revenue Officer from Chicago). This discussion was initiated because the Tip Rate Determination Agreements used by the gaming industry were not being accepted by tipped employees of the food service industry and, consequently, we wanted to explore the feasibility of restaurant employers negotiating a different agreement with the Service. With assurances from Mr. Burger that not only was the Service open to working on a market segment understanding with the food service industry, it would be willing to provide protection against retroactive assessments of employer FICA taxes for participating employers, I was tasked with approaching the National Restaurant Association and other restaurant employers to encourage participation in the negotiation process. Without the assurance from the Service on the issue of protection from retroactive assessments of employer FICA taxes, it is unlikely that I would have been able to persuade the industry to enter into negotiations with the Service.

Over the next 18 months, numerous meetings of IRS and industry representatives were held at various sites around the country to work out the details of the market segment understanding. The working group expanded to include other restaurant and hotel employers and representatives of the IRS Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). We were most fortunate that the IRS team was led by Tom Burger, who not only negotiated fairly with the industry, but encouraged open discussions about the industry's concerns with the IRS's interpretation and future administration of the market segment understanding agreement that came to be known as TRAC in March 1995.

B. **Employer's Obligations under TRAC.**

Section III. of the TRAC Agreement that both food service industry representatives and IRS representatives agreed to in 1995 requires a restaurant employer to:

1. establish procedures for tracking all tips reported by employees to the employer, so that the tips may be reported to the IRS;
2. educate and periodically update directly and indirectly tipped employees as to their obligation to report all the tips they receive as either direct tips from customers or as tip-outs from other members of the wait staff;
3. file all the requisite employment tax and information returns and to timely pay the appropriate taxes; and
4. to maintain certain tip reporting records and to submit to compliance reviews of those records at the request of the IRS.

It is noteworthy that the final version of the 1995 TRAC Agreement does not set forth any requirement that charged or cash tips must be reported at any particular levels, rates, or percentages, or within any particular range of one another.

C. **IRS's Commitment Under TRAC.**

In exchange for the employer's commitment under TRAC, the IRS agreed during negotiations—and as reflected in the final TRAC agreement—that during the calendar quarters that an employer is on TRAC, the employer could be assessed for its share of FICA taxes on unreported tips, but solely based on employee-by-employee data gathered by the IRS from individual employee tax returns or audits of the individual employees by the Service (Section IV.A. of the TRAC Agreement). In other words, the IRS agreed that an employer on TRAC would not be subjected to an Internal Revenue Code ("Code") 3121(q) aggregate assessment of the employer's share of FICA taxes.

D. **Working Group's Discussions Regarding TRAC Revocation.**

Consistent with the concern raised during the first informal discussion with Messrs. Burger, Cossey, and Warcholak of the IRS in March 1994, the TRAC working group had long and extensive discussions about the grounds for terminating a restaurant employer's participation in the TRAC program and whether the Service's revocation could be retroactive. The final version of the TRAC agreement, as negotiated by our working group, provides for only one circumstance in which a TRAC agreement may be revoked retroactively by the IRS.

Specifically, if a restaurant employer (or any of its establishments) fails to substantially comply with the commitment to educate employees and/or to establish and maintain tip-reporting procedures as discussed above, the employer's (or its establishment's) participation in TRAC may be revoked retroactively. This revocation is effective on the first day of the first calendar quarter in which there was substantial noncompliance. This provision does *not* permit the IRS to revoke a TRAC agreement retroactively based on the rate of charged or cash tips reported by the restaurant's employees. In other words, the TRAC Agreement does not authorize the Service to revoke the Agreement retroactively because the Service or one of its agents decides that the tip reporting rates should have been higher during the years of TRAC participation.

The TRAC working group's discussions on this point were vigorous. I distinctly remember the question that I directed to IRS representatives—"can the TRAC agreement be revoked retroactively, so as to expose the employer to a section 3121(q) assessment, if the IRS decides that the tips reported by employees during the restaurant's TRAC participation were not high enough?"

I was again reassured by Service personnel that retroactive revocation would not happen under those circumstances. The working group's collective understanding that such action would not be taken by the Service is in fact reflected in the final TRAC agreement. Moreover, terminating a TRAC Agreement prospectively for an underreporting of tips by employees even requires the IRS to do more than just decide unilaterally that the tip reporting rates were too low. The TRAC Agreement provides in Section V. that the IRS may prospectively terminate an employer's participation (or an establishment's participation) if an IRS audit of employees for two calendar quarters reveals that the employees collectively and substantially underreported tip income, despite the employer's substantial compliance with TRAC requirements. In other words, if the Service determines through audits of employees that they are not in "substantial compliance" with the requirement to report tips in spite of the employer's commitment to TRAC, the IRS is empowered to revoke the TRAC prospectively with respect to the employer or a particular establishment of the employer. The prospective revocation is effective on the first day of the first calendar quarter after the Service notifies the employer or the establishment that the Agreement is being terminated.

E. **Concern Regarding IRS's Apparent Shift in Interpreting TRAC Revocation Authority.**

We are deeply concerned to learn that the IRS recently had retroactively revoked a TRAC agreement of another restaurant employer apparently on the grounds that the employer was in substantial noncompliance, because the tip rates were not high enough. If an employer, which has met its commitments under a TRAC agreement, can be retroactively subjected to a Code section 3121(q) aggregate assessment of employer FICA taxes, the greatest fear of the food service industry members of the TRAC working group is being realized 10 years after the TRAC negotiations were completed.

We believe that the Subcommittee and the Service should consider whether this development puts the entire TRAC program at risk. No taxpayer and certainly no industry is willing to negotiate cooperative solutions with the Service and operate their businesses accordingly if IRS examiners feel free to change the deal when it suits them.

F. **Success of the TRAC Program.**

As the announcement for the Subcommittee's hearing noted, tip reporting has improved exponentially in the last decade, which is in no small measure due to the TRAC program and the exceptional efforts of Tom Burger and his team to work with the industry. Over 11,200 TRAC agreements have been signed by food service employers, covering nearly 31,000 restaurant establishments. Form 8027 reporting by large food and beverage establishments nearly doubled between 1994, the year before TRAC was released, and 2001—$4.73 billion in reported tips to $7.86 billion. An improvement in tip reporting of one-half of a percentage point reflects an additional billion dollars in reported tip income. Indeed, the TRAC program has been so successful; it has become the model for negotiating resolutions and market segment understanding agreements with taxpayers. Therefore, the IRS should continue to respect both the specific terms of the Agreement and the original intent of the program to work cooperatively with taxpayers.

G. **Conclusion.**

Darden is proud to have proposed the idea of an industry partnership with the Service and to have been the first signatory of a TRAC Agreement. We are prepared to continue that partnership, provided the Service is prepared to honor the agreement as negotiated a decade ago. We realize that the TRAC Program is scheduled to expire in 2005 and if the Service believes that the TRAC program needs to be revisited, we would be delighted to be a part of that discussion. In the interim, however, we would encourage the Service to rethink its apparent decision to revoke TRAC agreements retroactively for reasons not articulated by the Agreement that was painstakingly negotiated with the food service industry in 1994 and 1995. In addition, we would encourage the Service to direct its enforcement efforts toward improving compliance among restaurant establishments that should be filing Forms 8027 or those with tipped employees who are not participating in the TRAC program.