Boston College Law Review

Volume 7 | Issue 4 Article 13

7-1-1966

Taxation

David A. Mills

Follow this and additional works at: http://lawdigitalcommons.bc.edu/bclr

 Part of the Social Welfare Law Commons, and the Taxation-Federal Estate and Gift Commons

Recommended Citation

David A. Mills, *Taxation*, 7 B.C.L. Rev. 901 (1966), http://lawdigitalcommons.bc.edu/bclr/vol7/iss4/13

This Current Legislation is brought to you for free and open access by the Law Journals at Digital Commons @ Boston College Law School. It has been accepted for inclusion in Boston College Law Review by an authorized editor of Digital Commons @ Boston College Law School. For more information, please contact nick.szydlowski@bc.edu.

TAXATION

SECTION 313 OF THE 1965 SOCIAL SECURITY AMENDMENTS

Consistent with its manifest policy to expand social welfare coverage,[1] the United States Congress has recently extended social security coverage to over a million American workers[2] and, as a secondary and coincidental result, has subjected nearly a billion dollars of annual taxable income to more effective Internal Revenue control.[3] This was accomplished in Section 313 of the Social Security Amendments of 1965[4] by including, *inter alia*, a modification of the definitions of employee "wage" under the Social Security Act[5] and the Internal Revenue Code of 1954.[6] As amended, those definitions now include employees' tips for social security tax and benefit purposes and for income tax withholding. These innovations, relatively unnoticed because dwarfed by the "Medicare" aspects of the amendments, will hopefully make the Social Security Act of 1935[7] meaningful to employees in American "tip industries"[8] and make the federal income tax on the tip income received by those employees more collectable.[9]

I. Tips as Wages in Wage-Based Social Legislation

For purposes of this discussion, certain of our social welfare statutes may be considered "wage-based," inasmuch as they base rights, responsibilities or both, upon the amount of the employee's total wage. In these statutes, however,

> the diverse interests of employers and employees have variously influenced legislators to include, exclude, or ignore tips in the specification of wage items in enactments where the wage base was important.[10]

Social Security.—It is a common fact that waiters, bellhops, taxi drivers and employees in similar occupations receive a substantial portion of their income in tips.[11] Until the passage of the noted amendments, tips have

---

1 See S. Rep. No. 404, pt. 1, 89th Cong., 1st Sess. 2 (1965).

2 28 Social Security Adm'n Bull. 35 (1965).

3 Ibid. This amount is an estimate and a conservative one at that. Testimony before the Ways and Means Committee indicates that annual tip income in restaurants alone may total over $1½ billion. Executive Hearings Before the House Committee on Ways and Means on H.R. 1 and Other Proposals for Medical Care for the Aged, 89th Cong., 1st Sess., pt. 2, at 849 (1965) [hereinafter cited as House Hearings].

4 79 Stat. 286 (1965).

5 Social Security Act § 209, 49 Stat. 625 (1935), 42 U.S.C. 409 (1964).

6 Int. Rev. Code of 1954, § 3401.

7 49 Stat. 620 (1935), 42 U.S.C. §§ 301-1394 (1964).

8 The following industries or employee groups have been included in this category: Restaurants, hotels, barber shops, beauty parlors, railroad dining rooms and cars, pullman and station porters, taxicab drivers, and bootblacks. Needleman, Tipping as a Factor in Wages, 45 Monthly Lab. Rev. 1303, 1305 (1937).

9 See pp. 905-06 infra.

10 Williams v. Jacksonville Terminal Co., 315 U.S. 386, 404 (1942).

11 S. Rep. No. 404, supra note 1, at 112; Wages in Eating and Drinking Places in 27 Areas, June 1961, 85 Monthly Lab. Rev. 517 (1962). It has been estimated that 2 million

been excluded from the definition of "wage" in our wage-based social security system which fixes its employment taxes[12] and employee benefits[13] upon the recipient's total "wage." Tips, therefore, have been neither subject to social security taxes nor included in the computation basis for old age and retirement benefits. As a result, many employees in tip occupations have had to forego retirement,[14] and many families have been left with totally inadequate death benefits.[15] Indeed, an examination of tip employees' social security benefits based solely upon employer-paid wages clearly demonstrates that social security has been virtually non-existent for many service industry employees.[16]

Three aspects of the unique nature of the tip contributed to its previous exclusion from the social security definition of wage.[17] First, although it may be argued that "gratuity" is a misnomer when applied to tip, it is nevertheless apparent that its partially gratuitous nature has conflicted with the strictly compensatory denotation accorded to "wage."[18] It is submitted, however, that if the ultimate purpose of the Social Security Act is to be realized, substance must rule above mere form and terminology. Whether a payment is called a "gratuity," "tip" or "pour-boire,"[19] it is in the nature of a compensation[20]—a wage—and, as such, should be considered as a basis of computation in a system that attempts to provide a "substitutional" wage. The general social intent of a statute should not be frustrated for a group of workers because of the unique wage or compensation structure of their industry. Recognition of the nature of the tip payment as a wage substitute

---

Americans depend on tips for the greater part of their livelihood. The average waiter earns 4 times his employer-paid wage in tips; bartenders and taxicab drivers earn one-half their income in tips. In 1956, the head waiter at the Waldorf-Astoria went to prison on a government charge of tax evasion on $67,070—all income from tips. Newsweek, May 27, 1957, pp. 114-16.

[12] Int. Rev. Code of 1954, §§ 3103, 3111.

[13] See 64 Stat. 492 (1935), 42 U.S.C. § 415 (1964).

[14] See House Hearings, supra note 3, at 876.

[15] Death benefits are also computed upon the deceased employee's total "wage." 75 Stat. 131 (1961), 42 U.S.C. § 402(e) (1964).

[16] As an example, the average straight-time hourly wage (exclusive of tips) for waiters in several parts of the country is less than 50 cents per hour. Wages in Eating and Drinking Places in 27 Areas, supra note 11, at 518. The yearly earning based upon a 40-hour week would be slightly over $1,000, and the maximum family death benefit based upon this wage is $82.50 per month—considerably less than a family benefit of $368.00 per month based on an average yearly "wage" of $6,600. Social Sec. Adm'n, Tips as Wages 6-7 (Aug. 1965).

[17] 20 C.F.R. § 404.1027(k)(3) (1965) (wage definitions under social security).

[18] See Roberts v. Commissioner, 176 F.2d 221, 223-24 (1949), for a commentary on the nature of the gratuity. The case notes the following excerpt from the Journal of Sir Walter Scott:

> I like to pay postilions and waiters rather more liberally than perhaps is right. I hate grumbling and sour faces, and the whole saving will not exceed a guinea or two for being damned from Dan to Beersheba.

See Wechsberg, Traveler's Return, Atlantic Monthly, Oct. 1956, pp. 108-10.

[19] See 20 C.F.R. § 404.1026(a)(3) (1965):

> The name by which the remuneration is designated is immaterial. Thus, salaries, fees, bonuses, and commissions on sales or on insurance premiums, are wages within the meaning of the act if paid as compensation for employment.

has wisely become a controlling factor in the extension of social security coverage to tips.

Second, the private, unaccountable nature of a tip payment has not lent itself to our social security system where actuarial precision and auditing controls are demanded.[21] However, the unique employee tip reporting system prescribed by section 313 should eliminate most of the valid objections based upon uncertainty and imprecision.[22]

Third, and perhaps the aspect primarily responsible for the past exclusion of tips from social security coverage, has been the usual method of financing which requires the employer to pay a tax on the "wage" equal in amount to the employee's share.[23] Employers have been vociferous in maintaining that they should not be taxed on a wage that they do not pay, and over which they have no control.[24] This argument is fully eliminated by section 313, which exempts the employer from paying a tax on the reported tips.[25] The original House bill would have required the tax,[26] while the Senate version suggested treating the tips as self-employment income,[27] taxable only to the employee but at a higher self-employment rate.[28] The compromise bill as enacted raises an interesting question of preferential treatment for both employers and employees in the tip industries since their ultimate benefits will be computed upon an average monthly wage upon which only half a tax has been paid, with no resultant lessening of benefits.[29]

Workmen's Compensation.—While, before the reported legislation, tips were not considered as wages for social security purposes, they have

---

[20] Cf. Roberts v. Commissioner, supra note 18, which demonstrates the Internal Revenue policy of recognizing the compensatory nature of the tip; and In re Powers, 275 Mass 515, 176 N.E. 621 (1931), which draws an analogy between tips and employer-paid wages.

[21] Cf. supra notes 18, 19.

[22] Pursuant to Int. Rev. Code of 1954, § 6053(a), the employee is required to report periodically to his employer in writing the amount of tips that he has received. This is usually done on a monthly basis, although § 3102(c) gives permissible variations. The tips are deemed to be paid at the time they are reported to the employer. § 3401(f). To facilitate the reporting, the Treasury Department has issued booklets to tip employees (Forms 1070 and 1070A) which are designed for daily use by the employee. Cf. Anson v. Commissioner, 328 F.2d 703, 705 (1964):

> But the privilege of original self-assessment accorded the taxpayer carries with it the burden of support through the maintenance of records which clearly and accurately reflect income.

[23] Int. Rev. Code of 1954, § 3111.

[24] See House Hearings, supra note 3, at 827-28.

[25] This is accomplished by excluding the § 3111 employer tax from the provisions of the amendment. Int. Rev. Code of 1954, § 3121(q).

[26] H.R. 6675, 89th Cong., 1st Sess. (1965).

[27] See S. Rep. No. 404, supra note 1, at 112, 239 (1965).

[28] Int. Rev. Code of 1954, § 1401. The tax on self-employment wages is about 1½ times the regular employee rate.

[29] If a tip employee earns $1000 per year in employer-paid wages, and $3000 in tips, both the employer and the employee (in 1966) pay 5.8% on the $1000, while the $3000 is taxed to the employee only, with a resultant tax revenue of $290. If that $4000 were earned by a non-tip employee, both he and his employer would be taxed on the entire $4000 at 5.8%, resulting in an annual tax of $464, or $174 more than the wage tax of the tip employee, whose benefits, nonetheless, will be computed upon an identical basis.

traditionally been considered as "wages" for purposes of workmen's compensation.[30] The reasoning in the workmen's compensation cases is that tips are part payment for services received by the patron at the place of business of the employer and, in effect, save the employer some portion of wage payment.[31] Since a purpose of workmen's compensation is to provide a *substitute* wage,[32] that purpose is best fulfilled by including tip wages as well as employer-paid wages in the computation of the workmen's compensation award. These same considerations apply with equal force to the computation of the social security payment.

Minimum Wage.—Under minimum wage laws applicable to tip employees, some jurisdictions allow tips to count toward the employer's statutory wage responsibility. It is submitted that this view recognizes the *substantial* nature of the tip as a wage substitute, and has been reflected by the noted change in social security policy.

Under federal law tips may count as part of the minimum wage.[33] The courts begin with the assumption that the tips belong to the recipient[34] unless there is an agreement between employer and employee[35] that they be considered as part of the employee's wage.[36] Under such an arrangement, the employee reports his tips to his employer, who then makes up the difference between the reported tips and the prescribed minimum wage.[37]

Although there is little uniformity in the state law on this question, a few states provide lower standard wages for employees who customarily receive tips,[38] and six states expressly permit the counting of tips toward the wage.[39] The states which explicity exclude tips or make no mention of them in computing the minimum wage[40] fail to recognize that the tip is a substantial wage factor, and in doing so may be creating an inequity amongst tip and non-tip employees who work under the same wage scale.[41]

---

[30] In re Powers, supra note 20.

[31] Id. at 519, 176 N.E. at 622.

[32] See Horovitz, Current Trends in Workmen's Compensation 466, 469 (1947).

[33] Williams v. Jacksonville Terminal Co., supra note 10; Southern Ry. v. Black, 127 F.2d 280 (4th Cir. 1942); U.S. Dept. of Labor, Restaurant and Other Food Service Enterprises 6 (Feb. 1962).

[34] 315 U.S. at 397.

[35] In Williams v. Jacksonville Terminal Co., 315 U.S. 386 (1942), and Harrison v. Kansas City Terminal Ry., 36 F. Supp. 434 (W.D. Mo. 1941), station porters, admittedly covered by the federal minimum wage law, were given individual notices to the effect that their tips would henceforth be counted toward their wage. By their continued work they were held to have impliedly accepted the terms of the "announcement."

[36] Williams v. Jacksonville Terminal Co., 118 F.2d 324, 326 (1941), aff'd, 315 U.S. 386 (1942) (quasi agency theory).

[37] See cases cited note 35 supra.

[38] See U.S. Dept. of Labor, Restaurants and Other Food Service Enterprises 93 (Jan. 1964) for an exposition of the state variations.

[39] See West v. Egan, 142 Conn. 437, 115 A.2d 322 (1955).

[40] U.S. Dept. of Labor, supra note 38, at 92.

[41] Section 313 may play a part in extending federal minimum wage law to employees in restaurant and other food service establishments, who, as of now, have little or no minimum wage protection. In the states where they are included in minimum wage legislation, the rates are generally inadequate and the coverage often restricted. U.S. Dept. of Labor, id. at 86-89. Under federal minimum wage law, these industries are totally

It is suggested that the extension of social security coverage to tips, as effected in the noted amendments, demonstrates a logical and desirable extension of tip policy under workmen's compensation and the better minimum wage rule.

II. Tips as Taxable Income

Although tips are not specifically included in the definition of "gross income" in the Internal Revenue Code,[42] the Treasury Regulations[43] and reported decisions have invariably supported the rule that tips are taxable income.[44] Federal taxation of that income, however, has proven to be very ineffective.[45] The tip has not been subject to periodic tax witholding[46] because

> the cumulative amount of gratuities received is peculiarly within the knowledge of the recipient and is not subject to exact verification from records kept by the employer, the contributor, or others.[47]

Recent cases have been concerned with the collectability of the tax and the reasonableness of various formulae developed by the Internal Revenue Service to estimate the income of tipped taxpayers who have kept no records of their tips, or have produced inadequate proof of earnings.[48] The

---

exempted, due in part to the argument that tipping reduces the need for a minimum wage. Id. at 1. That argument, however, is not universally applicable, because tips are received by less than half of those exempted. Id. at 25.

Now, however, if federal law is extended to the entire industry, the tip employee would be exempted from its coverage to the extent of his reported tips, for under federal minimum wage law, tips reported to the employer may count toward that minimum wage. There is no reason why the section 313 tip report, although primarily for tax withholding purposes, could not serve this additional minimum wage purpose. The non-tip service employees would no longer be penalized for something they do not receive. This extension would also give the employer an interest in the veracity of the tip report, and would help insure it, for next to the recipient himself, the employer knows best the amount of his employees' tips.

[42] Int. Rev. Code of 1954, § 61.

[43] Treas. Reg. § 1.61-2(a)(1) (1957).

[44] In Roberts v. Commissioner, supra note 18, the tipped taxpayer made an unsuccessful assertion of the gratuitous nature of the tip. The court held that tips were given for a service (or at least, *better* service) and, hence, for a consideration. Mere lack of legal obligation to pay is not enough to establish a donative intent.

[45] See Carroll F. Schroeder, 40 T.C. 30, 33 (1963) where the court said: "This is another of a rash of 'tip' cases . . . recently . . . presented to us for decision."

[46] Int. Rev. Code of 1954, § 3401(a) deals with the definition of wages subject to withholding: ". . . remuneration . . . for services performed by an employee for his employer. . . ." See House Hearings, supra note 3, at 867.

[47] Anson v. Commissioner, supra note 22, at 705.

[48] The formulae in the following cases were considered reasonable: Anson v. Commissioner, supra note 22 (10% of a waitress' estimated gross sales); Mendelson v. Commissioner, 305 F.2d 519 (7th Cir. 1962) (10% of a waiter's estimated gross sales); Barry Meneguzzo, 43 T.C. 824 (1965) (a tip-to-wage ratio of two-to-one); Carroll F. Schroeder, supra note 45 (12% of a waitress' actual gross sales); Dorothy L. Sutherland, 32 T.C. 862 (1959) (100% of a waiter's wage; 66% of a waitress' wage); Nazzareno D. Caesanelli, 8 T.C. 776 (1947) (10% of a waiter's actual gross sales).

formulae indicate a growing awareness of tax delinquency in this area,[49] and it is no doubt true that

> in the background of all the deliberations [on section 313] was the fact that the government was determined to find a new approach to obtain more tax income from tipped employees.[50]

The tip reporting and witholding provisions of section 313 form that new approach. While their success will depend on the accuracy of the reporting, the motive to falsify has been mitigated substantially by two factors. First, both the social security benefits and the tax burden will rest upon the same reported figure.[51] This has placed the self-serving aspect of the report in balance: to overreport is to increase the income and social security tax,[52] and to underreport is to decrease social security benefits. Second, the availability of individual tip reports for comparison on an industry-wide basis will undoubtedly discourage inaccurate reporting by the taxpayer and encourage a more thorough analysis of returns by the Internal Revenue.[53]

III. Conclusion

Section 313 of the Social Security Amendments of 1965 offers a partial solution to social security and income tax problems of the tip employee. However, as long as tipping remains a private transaction between patron and recipient, it will never be subject to exact verification, and the tip report will to some degree remain a matter of good faith.[54] Further effort toward making the amount of the tip *more* certain might be attempted (1) by requiring the tipping patron to actively participate in the tip reporting process,[55] (2) by requiring the tip to be paid through the employer or (3) by replacing the traditional form of tipping with a service charge collected and disbursed by the employer.[56] The first suggestion is perhaps least workable as it would involve supervision of the tipping patron, virtually an impossible task. The second and third alternatives might detract from the *historical* reward/incentive aspect of the tip[57] but would make its wage-like nature more apparent.[58] Tipping does, in fact, save the employer from paying

---

[49] See Anson v. Commissioner, supra note 22.

[50] American Hotel & Motel Association, Washington Report, July 28, 1965, p. 1.

[51] Supra notes 12, 13; Int. Rev. Code of 1954, § 3402.

[52] See House Hearings, supra note 3, at 883, for a discussion of the potential over-reporting of tips to build up social security benefits.

[53] See Proposed Treas. Reg. § 31.310s-3(c)(2), 31 Fed. Reg. 966 (1966).

[54] Anson v. Commissioner, supra note 22.

[55] See ibid. Perhaps the patron would be required to notate the amount of the tip on a form maintained by the tip recipient or the employer. Cf. Forms 1070 & 1070A, supra note 22.

[56] See Restaurant & Patisseries Longchamps, Inc. v. Pedrick, 52 F. Supp. 174 (S.D.N.Y. 1943); Beaman v. Westward Ho Hotel Co., 89 Ariz. 1, 357 P.2d 327 (1960). In November 1959 the Soviet press campaigned for an end to tipping in Russian restaurants. A service charge of 4% was imposed (6% at the posh Praga) which failed, however, to stop the "under-the-teacup tribute." Time, Nov. 16, 1959, p. 41.

[57] Supra note 18.

[58] Supra note 19.

additional wages in many cases,[59] and it would not be grossly unfair to require his assistance to insure the correct reporting of that wage. It is interesting to note that under section 313 the employer's liability for the tax collection flatly ends if the employee fails to file the required tip report.[60] This unqualified freedom from liability decreases the effectiveness of section 313 and must eventually be modified.

DAVID A. MILLS

[59] See In re Powers, supra note 20.

[60] The employee may be subject to a very ineffective penalty for failure to report. See Int. Rev. Code of 1954, § 6652(c).