THE CASE AGAINST TIPPING

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I. INTRODUCTION

The New York Times recently reported that some upscale restaurants are considering replacing voluntary tips with a service charge.[1] This has an impact on not only the owners of the 200,000 full-service restaurants and the 3.8 million Americans who work in them,[2] but also on the general public, which dines or takes advantage of the other thirty-three occupations that are customarily tipped.[3] Tipping is a substantial component of the service-oriented economy in the United States. Restaurant, bar, and lodging tips have been estimated to amount to twenty-seven billion dollars a year.[4] Replacing a (voluntary) tip with a (mandatory) service charge would significantly improve the service industry, for the better.

Under conventional wisdom, tipping is a social norm that promotes social welfare. It is perceived to be an efficient way of monitoring service quality by allowing the customers, the people who are best positioned to

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1. Patrick McGeehan, *What, No Tip? Service Charge Faces Struggle At Restaurants*, N.Y. TIMES, Aug. 15, 2005, at B1.

2. *See* Ofer H. Azar, *Why Pay Extra? Tipping and the Importance of Social Norms and Feelings in Economic Theory*, J. SOCIO-ECON. (forthcoming 2006), *available at* http://ideas.repec.org/p/wpa/wuwpmi/0503005.html (citing from the United States Census Bureau, 2002, Table 1249, that "[i]n 2000 in the US, there were 192,342 full-service restaurants and 50,578 drinking spots (of alcoholic beverages), employing 3,897,100 and 328,600 employees, respectively").

3. Michael Lynn, George Zinkhan & Judy Harris, *Consumer Tipping: A Cross-Country Study*, 20 J. CONSUMER RES. 478, 482 (1993) (listing 33 occupations that are customarily tipped).

4. Ofer H. Azar, *Optimal Monitoring with External Incentives: The Case of Tipping*, 71 S. ECON. J. 170, 172 (2004).

assess the quality of the service, to decide how much to pay. Conventional wisdom, however, is likely to be misleading. Researchers have found that service quality has only a negligible effect on the size of the tip, which is mainly related to the size of the bill.[5] People typically tip fifteen to twenty percent of the bill (or double the sales tax plus change in places where the sales tax is around seven to eight percent), as long as the service is reasonable.[6]

The possibility that tipping reduces social welfare was recently discussed by Ayers, Vars, and Zakariya (Ayers et al).[7] They showed that tipping may facilitate prejudice. For example, they suggest that customers tend to discriminate against minority cab drivers.[8] In addition, the Ayers study suggests that minority passengers tend to leave lower tips, thereby giving cab drivers a revenue-based incentive to refuse to pick them up.[9]

This phenomenon extends to other minority service providers, such as waiters.[10] The switch to a service charge would prevent discrimination against minority service providers, because the decision to pay for service would not be left to the customer. In addition, it would eliminate the revenue-based incentive of service providers, such as waiters, to refuse to wait on minority customers.

In this paper I suggest two additional reasons to prefer a service charge over tipping. First, tipping may have a negative externality effect, explaining why the percentage of tips has increased from around ten to fifteen percent of the bill in the 1970s to 15-20 percent today.[11] It seems plausible to assume that as inequality grew in the United States, affluent people increased the amount they tip in order to improve their relative positioning or their status. This put pressure on those who are somewhat less affluent to increase the amount of tip that they leave, starting a cascade effect to the detriment of all. Evidence supports the view that expenditure cascades in housing and other areas are, at least in part, a consequence of increased income inequality.[12] Tipping is likely to be part of that trend. Hence, a switch to a service charge would be welfare enhancing.

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5. *See* discussion *infra*, Section II.

6. PEGGY POST, EMILY POST'S ETIQUETTE 532 (16th ed. 1997).

7. Ian Ayres, Fredrick E. Vars & Nasser Zakariya, *To Insure Prejudice: Racial Disparities in Taxicab Tipping*, 114 YALE L.J. 1613 (2005).

8. *Id.* at 1616.

9. *Id.*

10. Michael Lynn, *Ethnic Differences in Tipping: A Matter of Familiarity*, 45 CORNELL HOTEL & RESTAURANT ADMIN. Q. 12, 13 (2004).

11. See POST, *supra* note 6, at 532 ("It wasn't long ago that 15 percent of the bill, excluding tax, was considered a generous tip in elegant restaurants. Now the figure is moving toward 20 percent for excellent service.").

12. Robert H. Frank, *Positional Externalities Cause Large and Preventable Welfare Losses*, 95 AM. ECON REV. 137, 139 (2005).

Second, tipping facilitates significant tax evasion.[13] At least half of all cash tip income received goes unreported.[14] This costs the government and taxpayers billions of dollars every year.[15]

As explained in this paper, tax evasion could be significantly reduced even if the switch to a service charge did not take place. This could be done by viewing the tip as income of the business owner rather than the employee.

The main argument offered in this paper is that there is incoherence in the treatment of tips for purposes of tax and employment laws. On one hand, tips are considered "remuneration . . . deemed to have been paid by the employer" for the purpose of social security taxes.[16] On the other hand, minimum wage law requires employers to pay their employees $2.13 per hour under federal law, or the full minimum-wage under some states' minimum wage laws, even if the employees earn more than the minimum wage in tips.

These divergent views lead to partial and inconsistent enforcement of tax laws. Sales tax is not imposed on tip income, even though, logically following the character of tips as "wages, deemed paid by the employer," the tip is income of the restaurant; that is, payment for the service component of the meal. The employer's portion of social security taxes is enforced by presumptive taxation methods which tax the employer on aggregate tips. This practice was recently approved by the Supreme Court in the 2002 landmark case, *United States v. Fior D'Italia, Inc.*[17] However, the employees' portion of social security taxes was left outside the scope of that case. Additionally, employees' income taxes must be audited on an individual basis, a process too expensive for the Internal Revenue Service (IRS) to perform with the statistically meaningful frequency necessary to maintain deterrence.[18] The result is that there is tax evasion on a significant

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13. *See* Samuel Estreicher & Jonathan R. Nash, *The Law and Economics of Tipping: The Laborer's Perspective*, 54 AM. LAW & ECON. ASS'N ANN. MEETINGS 1 (2004), *available at* http://law.bepress.com/alea/14th/art54 (suggesting that tax evasion is the primary explanation for the phenomenon of tipping).

14. *See* Jody L. Spencer, *Bubble Room, Inc. v. United States: The Court of Federal Claims Says No to Aggregate Income Estimates for Employer-Only FICA Taxes*, 31 GA. L. REV. 1259, 1259 (1997) ("[T]he . . . IRS calculates that only twenty to twenty-five percent of waiters fully report the tips they earn each year, compared to an overall taxpayer-compliance rate of approximately eighty-five percent.").

15. *See id.* ("[S]ome government sources have concluded that the annual amount of unreported tip income may be closer to thirty billion dollars.").

16. 26 U.S.C. § 3121(q) (2000).

17. 536 U.S. 238 (2002).

18. Jennifer M. Erickson, *Fior D'Italia: The "Taxing" Problem of Unreported Tip Income*, 88 IOWA L. REV. 655, 658 n.20 (2003); *see also* Fior D'Italia, Inc. v. United States, 242 F.3d 844, 858 (9th Cir. 2001) (McKeown, J., dissenting) (explaining that the IRS "cannot possibly audit all tipped employees" because it lacks the resources to do so); 330 W.

percentage of tip income.

Switching to a service charge, or viewing tips as payment for services provided by employees will significantly mitigate the problem of tax evasion. Tips, which are in fact a payment for the service component of the meal, will be taxed in the same way that payment for food is taxed. They will be taxed to the employer, and any amount of tips that the employer chooses to give the employees, either directly or by allowing them to keep the tips they collect (usually the full amount), will be taxed like any other form of wages.

Taxing the tip income like regular wages will cure an important deficiency created by *Fior D'Italia*; the difference between social security taxes paid and employees' benefits accrued (and later received). Under the current rule, employers' social security taxes paid on unreported tip income are not reflected in the employees' social security benefit accounts. This is problematic because, as economists generally agree, employers shift the economic burden of social security taxes to employees by reducing their wages. Taxing tip income like any other form of wages will reestablish the link between taxes paid and benefits received, and will improve employees' financial security in the long run.

The paper continues as follows. Part I provides a brief history of tipping in an effort to show that although tipping seems to be a well established custom today, it was viewed as "un-American" as recently as a hundred years ago.[19] Part II discusses the efficiency rationales of tipping. Part III discusses the incoherent treatment of tips under tax and employment laws. Part IV concludes and offers some normative implications.

II. A BRIEF HISTORY OF TIPPING

No one knows for sure how the custom of tipping originated. An oft-repeated story is that tipping became common in coffee-houses ("penny universities") of 16th-century England and later in local pubs where brass urns were placed with the inscription "To Insure Promptitude".[20] Another

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Hubbard Rest. Corp. v. United States, 203 F.3d 990, 992 (7th Cir. 2000) (noting that auditing each employee would be "too burdensome" for the IRS); and Morrison Rests., Inc. v. United States, 118 F.3d 1526, 1528 n.3 (11th Cir. 1997) (noting that in the case at hand the IRS initially tried to audit each employee, but gave up after determining that such an assessment would not be "cost effective").

19. *See* KERRY SEGRAVE, TIPPING: AN AMERICAN SOCIAL HISTORY OF GRATUITIES 5-6 (McFarland & Co. 1998) (1944) ("What, may I ask, is more un-American than tipping? It doesn't belong in American society; it doesn't belong in a democracy. It is a product of lands where for centuries there has been a servile class.").

20. R. Keith Schwer & Rennae Daneshvary, *Tipping Participation and Expenditures in Beauty Salons*, 32 APPLIED ECON. 2023, 2024 (2000).

form of tipping developed in private homes in Tudor England, when visitors paid hosts' servants for their extra work in accommodating them.[21] The custom of tipping quickly spread throughout Europe, especially in areas that had a servant class, and by the 17th century, most establishments in Europe accepted tips.

Tipping did not take off in America until later, possibly because the country did not have a servant class. In the late 1800s, affluent Americans who traveled (and tipped) in Europe, began tipping in the United States as well, to show that they had been abroad and were familiar with European customs.[22] At first this was met with fierce opposition as fostering a master-servant relationship ill suited to a nation whose people were meant to be social equals.[23] People opposed tipping so strongly that, between 1909 and 1918, seven states passed anti-tipping laws.[24] All these laws, however, were repealed by 1926, when the concept slowly took off.[25] Business owners began to lower the wages of employees until tips were needed to supplement their income, and people became accustomed to the practice as a way to ensure the livelihood of workers in the service industry.[26]

Whereas in many countries, most notably in Europe where the practice originated, a service charge is now the norm, tipping has become quintessentially American. Consumers of yesterday left no more than 10 percent on fountain counters. Beginning in the late 1970s, the going rate rose to 15 percent and it is steadily edging toward 20 percent.[27] A decade ago it was rare for tips to be brazenly solicited for counter service, but in today's coffeehouses and juice joints, with their "tip jars," it has become de rigueur.

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21. *See* SEGRAVE, *supra* note 19, at 1-2 ("In time, these payments were expected from every guest even if no special service was rendered, resulting in people avoiding visiting their friends because of the high costs associated with doing so.").

22. Ofer Azar, *The History of Tipping – from Sixteenth-Century England to United States in the 1910s*, 33 J. SOCIO-ECON. 745, 759 (2004).

23. *See* WILLIAM R. SCOTT, THE ITCHING PALM: A STUDY OF THE HABIT OF TIPPING IN AMERICA 38 (1916) ("Every tip given in the United States is a blow at our experiment in democracy.").

24. Ayres et al., *supra* note 7, at 1660.

25. Herman Steutzer, Jr., Note, *Workmen's Compensation: Basis for Computation: Tips as Earnings or Wages*, 17 CORNELL L.Q. 183, 188 n.41 (1931).

26. *See* Leo P. Crespi, *The Implications of Tipping in America*, 11 PUB. OPINION Q. 424, 426 (1947).

27. See POST, *supra* note 6, at 532.

III. EXAMINING THE CONVENTIONAL EFFICIENCY RATIONALE

A. Is Tipping Efficient?

Tipping allows customers to provide incentives to waiters because they are in a better position than the restaurant owner (the employer) to monitor and reward server effort. Monitoring of service quality is costly to the employer but practically free to the customer. Therefore, tipping may be viewed as an informal service contract between the customer and the waiter, acting as a consumer-monitoring mechanism.[28] Moreover, tipping saves on litigation costs; that is, the need for a customer to prove to a restaurant owner that the service was bad and demand a reduction in the service charge. If the service was bad, the customer can simply leave a small tip or no tip at all.

However, such a consumer-monitoring mechanism is subject to the problem of free riding. Free riding is a type of market inefficiency that usually requires government intervention.[29] The best-known example of market intervention, justified primarily by the free riding problem, is the tax system. The government provides public goods, such as protection provided by the police or the military, which, once made available, no one can be stopped from consuming for free. Since rational individuals are expected to avoid paying for goods they can consume for free (free ride), the amount of public goods provided will be much lower than what people would want it to be. The government imposes taxes to finance public goods thus solving the collective action problem and promoting efficiency.

Tipping is also subject to this type of market inefficiency. Even consumers who do not leave a tip benefit from good service at lower cost (assuming that savings in monitoring costs enabled by the practice of tipping will be shared by employers and patrons by the reduced price of meals), as long as others leave tips according to service quality. Customers who expect to return in the near future to the same establishment may leave a tip to ensure future good service, but all others have an incentive to free ride.

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28. *See* Michael Lynn, *Restaurant Tipping and Service Quality: A Tenuous Relationship*, 42 CORNELL HOTEL & RESTAURANT ADMIN. Q. 14, 15 (2001) (discussing how employers may rely on such a mechanism for management purposes). For example, a restaurant in Houston provided its employees with a document saying: "This program will be monitored by your charge tip averages. Tip averages are the most effective way to measure a server's capabilities and progress within the restaurant." *Id.*

29. For a classic view of the problem of free riding, see Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 R. ECON. & STAT. 387 (1954).

B. *Tipping as a Social Norm*

Since individuals are generally presumed to act in their own self-interest, namely to take advantage of an opportunity to free ride, the widespread phenomenon of tipping poses a puzzle for traditional economics. People tip even though they are not legally obligated to do so. Traditional economic analysis can explain tipping only as an investment in future good service. This explanation is relevant only in the case of repeated customers and suggests that one-time customers would not tip.[30] However, studies show that people tip as well in out-of-town restaurants as they do at local ones.[31] Hence traditional economic analysis cannot explain the phenomenon of tipping, and must be augmented by incorporating the notion of social norms.

Social norms may provide an enforcement mechanism by weakening the incentive of customers to free ride. Social norms are "social attitudes of approval and disapproval, specifying what ought to be done and what ought not to be done."[32] In tipping, people seek the social approval of others dining with them, as well as that of the waitress. The latter explains why people tip even when dining alone; people tip because they are embarrassed not to. This embarrassment is due to the existence of the social norm of tipping. Hence, people in Japan do not feel embarrassed at not tipping waiters because tipping is not a social norm there.[33] Likewise, people in the United States do not tip flight attendants, because even though flight attendants provide services that are quite similar to the services provided in restaurants, social norms do not include flight attendants in the category of tipped service providers.[34]

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30. Uri Ben-Zion & Edi Karni, *"Tip" Payments and the Quality of Service*, *in* ESSAYS IN LABOR MARKET ANALYSIS 37 (Orley C. Ashenfelter & Wallace E. Oates eds., 1977).

31. *See* Daniel Kahneman, Jack Knetsch & Richard Thaler, *Fairness as a Constraint on Profit Seeking: Entitlements in the Market*, 76 AM. ECON. REV. 728 (1986) (showing answers indicating that people do not think that frequent patrons tip more, suggesting that ensuring the quality of future service is not an important reason for tipping).

32. Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 914 (1996). *See also*, Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1127 (2000) (discussing the definition of social norms).

33. *See, e.g.*, Japanese Manners and Etiquette, http://www.geocities.com/japanfaq/FAQ-Manners.html (last visited October 23, 2006) ("There is no tipping in Japan."). *See also* World Hotels and Resorts Direct, Tokyo Hotels and City Guide – Local Customs, http://www.worldexecutive.com/cityguides/tokyo/tips.html (last visited October 23, 2006) (suggesting that the Japanese may even consider tipping to be vulgar).

34. I assume that the possibility that flight attendants might provide passengers with numerous amenities at the expense of the airline company, such as upgrading to business or first class, led airline companies to prohibit flight attendants from accepting any tips, thereby affecting the development of an exclusion to the social norm of tipping service

Even when social norms cannot be enforced through direct social sanctions, such as in the case of dining abroad, people usually consider it unfair not to tip, unless they received really bad service, because they have internalized the social norm. Moreover, people know that although the service component of the meal was not included in the bill, it was not meant to be free. They know that the reason for not including service in the bill was the expectation that they would pay for it by leaving a tip. Therefore, most people would feel that they were stealing if they left a restaurant without paying for the service in the form of leaving a tip, even though it would be legal to do so.[35] Psychological game models show that guilt aversion can induce people to pay in situations where no sanction, legal or social, is available.[36] Other plausible explanations could be altruism or empathy for the waiter who is often perceived to be hard-working and poorly paid by his employer.

C. *Is Tipping a Desirable Social Norm?*

Nobel laureate Kenneth Arrow suggested that social norms could be "reactions of society to compensate for market failures,"[37] and that "[t]here is a whole set of customs and norms which might be similarly interpreted as agreements to improve the efficiency of the economic system (in the broad sense of satisfaction of individual values) by providing commodities to which the price system is inapplicable."[38] As discussed above, tipping may be efficient if it saves on service-quality monitoring costs, because customers are better positioned than employers to asses the quality of service. In this instance, the social norm of tipping may be an example of "reactions of society to compensate for market failures,"[39] namely the possibility of free riding. If that is the case, then tipping is an efficient

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providers. *See* Saul Levmore, *Norms as Supplements*, 86 VA. L. REV. 1989, 1994-95 (2000) (raising the possibility that waiters would offer customers free drinks, at the employer's expense, in the hope of increasing their tips).

35. Such norms are often referred to as "internalized norms." *See, e.g.,* Jon Elster, *Social Norms and Economic Theory*, 3 J. ECON. PERSP. 99 (1989) (discussing the rationality of tipping); and Richard A. Posner & Eric B. Rasmusen, *Creating and Enforcing Norms, with Special Reference to Sanctions*, 19 INT'L. REV. L. & ECON. 369 (1999) (describing incentives in tipping).

36. Martin Dufwenberg & Georg Kirchsteiger, *A Theory of Sequential Reciprocity*, 47 GAMES & ECON. BEHAV. 268 (2004).

37. Kenneth Arrow, *Political and Economic Evaluation of Social Effects and Externalities*, *in* FRONTIERS OF QUANTITATIVE ECONOMICS 3 (M. Intriligator, ed., 1971) (finding that market failures create externalities in public goods). *See also*, Ofer Azar, *The Social Norm of Tipping: Does it Improve Social Welfare?*, 85 J. ECON. 141 (2004) (quoting Arrow to substantiate his claim that tipping is efficient and welfare enhancing).

38. Arrow, *supra* note 37.

39. *Id.*

social norm.

There is, however, a possible flaw in the above efficiency argument. The argument that tipping is efficient is based on the assumption that customers tip according to service quality, whereas in reality there is only a weak correlation between service-quality and tip size.[40] By far the most important factor that determines tip size is the size of the bill and there is no reason to think that the size of the bill is correlated with service quality.[41] Researchers have found that the average relationship between tip size and service evaluations by customers is quite small, accounting for less than two percent of the variability in tip percentages.[42] Such small variability is unlikely to affect the service provider's behavior.[43] Others

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40. *See* April Crusco & Christopher G. Wetzel, *The Midas Touch: The Effects of Interpersonal Touch on Restaurant Tipping*, 10 PERSONALITY & SOC. PSYCHOL. BULL., 512 (1984) (finding that the use of touching among waitresses, under certain circumstances, significantly increased tipping rates); Michael Lynn & Bibb Latane, *The Psychology of Restaurant Tipping*, 14 J. APPLIED SOC. PSYCH. 549 (1984) (finding numerous psychological variables affect customers tipping rates); Michael Lynn, *The Effects of Alcohol Consumption on Restaurant Tipping*, 14 PERSONALITY & SOC. PSYCHOL. BULL. 87 (1988) (study finding that the consumption of alcohol among customers positively increase the rate of tipping); and Michael Lynn & Andrea Grassman, *Restaurant Tipping: An Examination of Three "Rational" Explanations*, 11 J. ECON. PSYCHOL. 169 (1990) (finding that tipping was related to a number of factors including the size of the bill, number of courses, and alcohol consumption).

41. The size of the bill is related to the price of the items on the menu and to the number of items. The latter is correlated with service, but not with the quality of the service. Tipping may therefore be correlated with quantity of service, but such a correlation does not save on monitoring costs because a fixed percentage service charge would compensate the waiters for their extra effort in bringing many dishes to the table, as the number of orders affects the size of the bill. *Cf.* Orn B. Bodvarsson & William A. Gibson, *Economics and Restaurant Gratuities: Determining Tip Rates*, 56 AM. J. ECON. & SOC. 187 (1997) (suggesting exactly the opposite conclusion; namely, that the high correlation between tips and bill size is driven by a high correlation between tips and quantity of service).

42. *See* Michael Lynn & Michael McCall, *Gratitude and Gratuity: A Meta-Analysis of Research on the Service-Tipping Relationship*, 29 J. SOCIO-ECON. 203, 211 (2000) (suggesting that there is a poor correlation between service quality and tipping size).

43. *See* Michael Lynn, *Restaurant Tipping and Service Quality: A Tenuous Relationship*, 42 CORNELL HOTEL & RESTAURANT ADMIN. Q. 14 (2001) (explaining the effect of variability in tipping rates); Michael Lynn, *Tip Levels and Service: An Update, Extension and Reconciliation*, 44 CORNELL HOTEL & RESTAURANT ADMIN. Q. 139, 148 (2003) (referring to research that shows that managers ought not to use tips to encourage good service among servers). Empirical studies found that repeated customers do tend to leave higher tips than non-regular customers, but the difference was very small, only one or two percent. *See* Bodvarsson & Gibson, *supra* note 41, at 190 (showing that even repeat customers do not tip to ensure good service in the future); Michael Conlin, Michael Lynn & Ted O'Donoghue, *The Norm of Restaurant Tipping*, 52 J. ECON. BEHAV. & ORG. 297 (2003) (showing that tips of frequent patrons are not more sensitive to service quality than tips of non-frequent patrons); Lynn & Grassman, *supra* note 40, at 171 (describing incentives in tipping).

have found tipping to have no effect on service quality at all.[44]

Moreover, most restaurants practice tip-pooling; that is, tips do not go directly to the staff who provided the service, but instead are aggregated and then distributed to all servers according to some formula. Tip-pooling is required to prevent harmful competition among wait-staff for customers who are expected to be generous tippers, and to promote collective efforts, thus providing better service over-all.[45] Tip-pooling reduces the incentive to provide good service that tipping allegedly provides. Each waiter or waitress has an incentive to free ride on the 'wait staff's efforts by exerting less effort in providing good service, as his or her tips will only be marginally affected.

To sum up, there is no clear theoretical case that supports tipping on efficiency grounds, and empirical studies find that the tipping effect is either small or non-existent.

D. Tipping as a Form of Negative Externality

It is possible that the social norm of tipping is not only ineffective, as there is weak correlation between service quality and the size of the tip, but in fact *creates* a market failure instead of resolving one. Seventy percent of the people answering a poll conducted on the www.tipping.org website answered "yes" to the question "Do you feel pressured to tip at a restaurant even if you feel you received bad service?"[46] This seems to prove that the social norm of tipping is so strong that many people feel extorted to tip. They are embarrassed not to leave a tip; that is, to pay an extra fifteen to twenty percent over the cost of the meal, even when they think the service was bad.

I would like to suggest that the social norm of tipping may be inefficient even when people are satisfied with the quality of the service they received. The way I see it, tipping may be a case of a negative externality imposed by wealthy people on the rest of society. Negative externality is the harmful effect of one economic agent's actions on another. It is considered inefficient because the first agent does not internalize the costs inflicted on the other by her behavior. Pollution is a

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44. *See, e.g.*, Kahneman et al., *supra* note 31.

45. Michael Lynn, *Tipping*, *in* INTERNATIONAL ENCYCLOPEDIA OF HOSPITALITY MANAGEMENT, 620 (Abraham Pizam ed., 2005). *See also* Levmore, *supra* note 34, at 1995 (discussing another possible situation of destructive competition where customers compete for the services of a single provider, concluding that such a collective action problem "reduces the efficiency of the tipping supplement and makes a positive theory more difficult.").

46. The Original Tipping Page, Polls, http://www.tipping.org/TopPagePollsResults.shtml (last visited, Jan. 29, 2006).

classic example. A factory which pollutes in the process of production, or a person who smokes a cigarette, are not intentionally harming others. Nevertheless, they do not internalize the costs they inflict on others and, therefore, pollute to a greater extent than is socially optimal, unless the law intervenes.

Accumulation of wealth and conspicuous consumption may create a negative externality as well, because people care about their relative position and spend on items such as housing, cars and clothes, to be at least as visibly impressive as others who spend lots of money on the same things. Economic models that incorporate positional concerns predict that sharply increased spending by top earners will exert indirect upward pressure on spending by the median earner.[47] This results in over-consumption, less leisure time, and an overall decrease in welfare.

Similarly, people who tip may be perceived as imposing a negative externality on others who tip less generously or do not tip at all. I suggest that the increase in the size of tips in the United States, from ten to fifteen percent in the nineteen seventies to the current norm of fifteen to twenty percent, may be the outcome of such negative externalities. This is certainly a more plausible explanation than an efficiency-based one; namely, that employer monitoring costs increased during that time period, and therefore, tipping became more efficient. Consequently, it justified a more forceful enforcement mechanism. I suggest that as inequality grew in the United States, affluent people increased the amount they tipped in order to improve their relative positioning; that is, their status. This put pressure on those who are somewhat less affluent to increase the amount of tip that they left, beginning a cascade effect to the detriment of all. Evidence supports the view that expenditure cascades in housing and other areas are at least in part a consequence of increased income inequality.[48] Tipping seems to me to be part of that trend.

E. Tipping May Facilitate Prejudice

As shown by Ayres et al., customers tend to discriminate against minority cab drivers.[49] Moreover, minority passengers tend to leave lower

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47. Robert H. Frank devoted much of his research work to this issue. *See, e.g.*, ROBERT H. FRANK, LUXURY FEVER: WHY MONEY FAILS TO SATISFY IN AN ERA OF EXCESS (2000); Robert H. Frank & Cass R. Sunstein, *Cost-Benefit Analysis and Relative Position*, 68 U. CHI. L. REV. 323 (2001) (discussing the cost-benefit analysis of regulatory issues).

48. *See* Frank, *supra* note 12 (showing that income inequality results in expenditure cascades).

49. Ayres et al., *supra* note 7, at 1627 (stating that"[w]hite drivers are tipped substantially more than black (or other) drivers whether measured either in terms of the average tip amount or the average tip percentage. White drivers were tipped sixty-one percent more than black drivers (20.3% versus 12.6%) and sixty-four percent more than our

tips thereby giving cab drivers a revenue-based incentive to refuse to pick them up.[50] This phenomenon extends to other minority service providers, such as waiters. Research in restaurants suggests that this variance in tipping behavior is influenced not only by perceived differences in service levels, but also by such factors as the ethnicity of the tipper or the server.[51] Waiters are likely to exert less effort when providing services to minority customers, assuming that, because minority customers are less likely to tip, they will not pay the waitstaff for their efforts. It is also possible that customers leave lower tips or no tip for minority waiters more often than for white waiters, for the same reason that they do so to minority cab drivers.

Ayres et al. propose a mandated switch to a service charge.[52] This may not eliminate the norm of tipping but is likely to reduce it significantly, as customers who know they have already been charged for the service are much less likely to leave a significant tip. The switch to a service charge will prevent discrimination against minority service providers, because the payment for service will not be left to the customer's good will and will eliminate the revenue-based incentive of service providers, such as waiters, to refuse to wait on minority customers.

Ayers et al. raise two countervailing effects.[53] The first is that for customers who currently do not tip, or who leave a lower percentage than what would be the service charge, switching to a service charge would increase the cost of the meal. This may have a disparate impact on minorities as they tend to have lower incomes.

'other minority' drivers (20.3% versus 12.4%). Put simply, passengers systematically tipped white drivers substantially more than nonwhite drivers.").

50. *Id.* at 1628-29 (explaining that "the average tipping percentage of black passengers in our data was only 42% of the average tipping percentage of white passengers (9.2% versus 21.6%). The tipping percentage of Hispanic passengers was only slightly more than half of the white-passenger tipping percentage (12.0% versus 21.6%). And Asian passengers tipped only seventy-five percent of the white-passenger tipping percentage (16.2% versus 21.6%). . . . [B]lack passengers in our data were 3.7 times more likely to stiff than white passengers, and Hispanic passengers were 3.2 times more likely (39.2% and 34.3% stiffing rates for blacks and Hispanics respectively versus only 10.6% for whites.")).

51. *Id.* at 1641 (explaining that "[t]he statistical discrimination based on perceived racial tipping differences may not be limited to the taxi industry"); Lynn, *Ethnic Differences In Tipping*, *supra* note 10, at 12 (arguing that "[m]any waiters and waitresses believe that African-Americans tip less than Caucasians . . . . As a result of that belief, many table servers dislike waiting on black customers, deliver inferior service to black guests on whom they must wait, and refuse to work in restaurants with a predominantly black clientele."). *See also* Michael Lynn, *Black-White Differences in Tipping Various Service Providers*, 34 J. APPLIED SOC. PSYCHOL. 2261 (2004) (revealing racial tipping patterns in the restaurant industry).

52. Ayres et al., *supra* note 7, at 1658-60.

53. *Id.*, at 1661-62 (describing the effects of tipping).

I do not find this argument compelling.[54] I think that we should not have a system that redistributes income at the cost of discrimination. A minority group member who pays less for a meal or a taxi ride by stiffing the waiter incurs a non-monetary cost. It is inefficient because the waiter does not gain anything from it. Additionally, it is immoral because people should not be put in a position in which they sell their pride; that is, strengthen prejudice against their racial group, in order to lower the cost of a meal or a taxi ride.

We should, in general, rely on the tax and transfer system to achieve redistribution.[55] Legal rules may have a supplementary role,[56] but it is wrong to see a virtue in a social norm (tipping), which is an informal legal rule that requires lower income people to pay for the income redistribution by experiencing the service industry's prejudice. Moreover, high income minority group members, or minority group members who are relatively less frequent users of tipped services such as restaurants and taxi rides, suffer from prejudice to allow for redistribution towards their fellow minority group members. A sound redistributive system, such as the tax and transfer system, imposes the redistributive burden according to income and does not reinforce prejudice.

The second countervailing effect that Ayres et al. raised is that tipping may be an efficient way to monitor service quality. They acknowledge, however, that although it makes sense (but only with regard to repeat customers), it has not been empirically proven to be of any significance, as tip size is, by and large, a function of bill-size and the variance in tip percentages that reflect service quality is less than two percent.[57]

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54. Ayres et al. argue that this would depend on "whether we view a tip as a discretionary gift to a driver or as an earned portion of driver compensation." *Id.* This, however, is not entirely relevant. If tips were gifts (which they are not), it would not be morally wrong to stiff a waiter. Nevertheless it would still be contrary to the social norm and would result in prejudice, as Ayres et al. themselves show in their paper.

55. *See* Louis Kaplow & Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 677 (1994) (explaining the lack of comparative efficiency of the legal system in redistributing income).

56. *See,* Tomer Blumkin & Yoram Margalioth, *On the Limits of Redistributive Taxation: Establishing a Case for Equity Informed Legal Rules*, 25 VA. TAX REV. 1 (2005) (describing the instances in which taxation is used for wealth redistribution); Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 N.Y.U. TAX L. REV. 157 (2003) (discussing the inefficiency of using legal rules for redistribution of wealth); Chris W. Sanchirico, *Taxes Versus Legal Rules as Instruments for Equity: A More Equitable View*, 29 J. LEGAL STUD. 797 (2000) (discussing the use of legal rules as instruments of equity).

57. They argue, however, that most of these studies suffer from the problem of restricted range. *See* Ayres et al., *supra* note 7, at 1662. *But see* Orn B. Bodvarsson & William A. Gibson, *An Economic Approach to Tips and Service Quality: Results of a Survey*, 36 SOC. SCI. J. 137 (discussing the fact that service quality is only a small portion of differentiation in tipping).

IV. THE INCOHERENT TREATMENT OF TIPS FACILITATES SIGNIFICANT TAX EVASION

Another important factor that must be accounted for in evaluating the social norm of tipping is its detrimental effects on the enforcement of sales tax and taxes on wages which include income tax, Federal Insurance Contribution Act taxes (popularly known as Social Security taxes or FICA taxes), Medicare, and State and Federal unemployment tax.[58] The IRS estimated that the only type of revenue with a lower compliance rate is illegal income.[59] The IRS can trace tips paid by credit card but tips paid in cash can be easily evaded by waiters.

Employers are required to withhold state and federal income taxes as well as Social Security[60] and Medicare[61] taxes from their employees' wages.[62] Employers are also required to pay a matching amount of Social Security and Medicare taxes for their employees and to pay State and Federal unemployment tax (SUTA and FUTA).[63]

Tips are considered part of wages for tax purposes.[64] Section 102(a) of the Internal Revenue Code (IRC) excludes gifts, bequests and inheritance from the donee's income. Tips could be considered a common law gift

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58. *See* Estreicher & Nash, *supra* note 13 (discussing, generally, the impact of tipping on taxes).

59. Steven Zanon, *Employer's Burden: Reporting Tax on Tip Income*, CPA J. ONLINE (Feb. 1991), *available at* http://www.nysscpa.org/cpajournal/old/10428232.htm (noting that the IRS estimates that eighty-four percent of tip income is never reported).

60. *See* 26 U.S.C. § 3101 (2000) (showing the social security tax rate is 6.2%); 26 U.S.C. § 3102 (2000). The wage base for social security tax is $94,200 for the year 2006. Once that amount is earned, neither the employee nor the employer owes any social security tax.

61. The social security tax rate is 1.45 percent. 26 U.S.C. § 3111 (2000). There is no wage base limit for the Medicare portion of the FICA tax.

62. The employer is responsible for deducting and depositing the employee's FICA tax on tips included in the written report furnished by the employee to the extent that collection can be made from the employee's funds on or after the time the written statement is furnished. The employee's funds include wages (exclusive of tips) in the employer's possession and amounts turned over to the employer by the employee. Treas. Reg. § 31.3102–3.

63. "The FUTA tax rate is 6.2% of taxable wages. The taxable wage base is the first $7000 paid in wages to each employee during a calendar year. Employers who pay the state unemployment tax, on a timely basis, receive an offset credit of up to 5.4% regardless of the rate of tax they pay the state. Therefore, the net federal tax rate is generally 0.8% (6.2% - 5.4%). This would equate to a maximum of $56.00 per employee, per year (.008 X $7000 = $56.00) in federal tax." U.S. Dept. of Lab. Emp. & Training Admin., Unemployment Insurance Tax Topic, http://workforcesecurity.doleta.gov/unemploy/uitaxtopic.asp (last visited October 23, 2006) (describing unemployment and tax consequences).

64. *See* I.R.C. §61 (2000) ("gross income means all income from whatever source derived."); Treas. Reg. § 1.61-2(a)(1) (2003) (stating that tips are income).

because they are paid on a voluntary basis.[65] However, for income tax purposes, the term "gift" was defined by the Supreme Court in the 1960 landmark case, *Commissioner v. Duberstein*, to exclude tips.[66]

The Court has indicated that voluntary transfer of property, without any consideration or compensation, is not necessarily a "gift" within the meaning of the income tax code.[67] If the payment proceeds primarily from "the constraining force of any moral or legal duty," or from "the incentive of anticipated benefit" of an economic nature,[68] it is not a gift for tax purposes. As discussed above, a tip is enforced by a social norm, and could therefore be considered to proceed from the constraining force of a "moral duty," hence it is not a gift for tax purposes.

Moreover, the Court cited *Robertson v. United States* stating that "where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it,"[69] and stated in footnote seven that "[t]he cases including 'tips' in gross income are classic examples of this."[70] Hence, tips constitute taxable income, either because they are enforced by a moral duty, or because they are payment in return for services rendered.

For the purpose of FICA taxes, Section 3121(q) specifies that "tips received by an employee in the course of his employment shall be considered remuneration" and "deemed to have been paid by the employer."[71]

To sum up, tips are included in the wage base for payroll taxes. As mentioned above, payroll taxes are not the only taxes evaded when cash tips are not reported by waiters; sales taxes are evaded as well.

A sales tax is a charge that is added to purchases of goods and some services in retail stores and restaurants. Sales taxes are assessed on sales

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65. Indeed, employment law imposes restrictions on arrangements between tipped employees and the employer in which any part of the tip becomes the property of the employer. For further discussion of the difference between tax and employment laws in their treatment of tip income, *see infra* Part III.

66. Duberstein v. Comm'r, 265 F.2d 28 (6th Cir. 1959), *rev'd*, 363 U.S. 278 (1960).

67. *Id.* at 285 (citing Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 730 (1929)).

68. Bogardus v. Comm'r, 302 U.S. 34, 41 (1937).

69. Robertson v. United States, 343 U.S. 711, 714 (1952)

70. *Duberstein*, 363 U.S. at 285 n.7. *See also* Treas. Reg. § 1.61-2(a)(1) (2003) (stating that tips are income); Cracchiola v. Comm'r, 643 F.2d 1383 (9th Cir. 1981) (holding tips were income under Internal Revenue Code).

71. I.R.C. §3121(q) (2000). However, for both the employer and the employee taxable tip income is limited to income within what is known as the "wage band;" there is no tax on tips that amount to less than $20 in a given month, *Id.* § 3121(a)(12)(B) (2000), or on total remuneration in excess of the annual Social Security wage base, which is $94,200 in 2006. *See* Social Security Online, Contribution and Benefit Base, http://www.ssa.gov/OACT/COLA/cbb.html (last visited October 23, 2006) (listing the history of the Old-Age, Survivors, and Disability Insurance benefit base).

transactions occurring within the boundaries of the taxing jurisdiction.[72] A restaurant must charge a fixed percentage as sales tax, which varies by state, county and city. In New York City, for example, it is currently 8.625% of the price of the meal, as both New York State and City impose a tax on the sale or use of various items, including food and beverages sold by restaurants and caterers. The New York City rate is 4.375% and the State imposes an additional 4.25%.[73] If the service component is charged separately, through a tip, it does not appear in the bill, and sales tax is evaded.

To get a sense of the impact that the choice between a service charge and a tip might have on the amount paid in taxes, let us examine the following example. A waiter earns $100 in tips. First, sales tax is not imposed on tips; hence the payment for the service component of the meal is sales tax free, when the service is paid for through tips. As for payroll taxes, waiters usually declare some of their tip income, so we will assume that he declares half, that is, fifty dollars. This amount is subject to both FICA taxes, which are around fifteen percent, and to income taxes, which are on average thirty percent, both state and federal.[74] Because the waiter may accrue expected Social Security benefits by paying the FICA taxes, I follow Shaviro in assuming a ten percent FICA tax rate, instead of fifteen percent.[75] So, of $100 in tips, eighty dollars go to the waiter and twenty dollars to the Treasury.

Consider now the case of a service charge. Of a $100 service charge, around eight percent is paid as sales tax. The remaining ninety two dollars is subject to FICA and income taxes, adding up to about thirty seven dollars. So, of a $100 service charge, fifty five dollars go to the waiter and forty five dollars to the Treasury.

In the above example I treated FICA taxes paid by the employer as if they were paid by the employee. In doing so I relied on the conventional wisdom that the employer's share of these payroll taxes is borne by the worker in the form of reduced wages. That is, employers reduce the wages

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72. PRENTICE HALL, PRENTICE HALL'S GUIDE TO SALES AND USE TAXES 57 (1988).

73. NEW YORK CITY DEP'T OF SMALL BUS. SERVICES, NEW YORK CITY RESTAURANT BUSINESS GUIDE 15, *available at* http://www.nyc.gov/html/sbs/html/nycbs/pdfs/pdfs_bsc/restaurantguide.pdf.

74. Assuming the waiter is in the middle class income range, and further assuming for the sake of simplicity that the tip income discussed in the example is his marginal income.

75. The FICA tax rate is actually lower than 15.3 percent (6.2%+1.45% employee tax plus 6.2%+1.45% employer tax) because the employer's nominal portion of the tax is excluded from the wage base in determining both parties' tax liabilities. Thus, the true tax rate, computed as a percentage of the employer's total outlay, is only 14.2 percent. *See* Daniel N. Shaviro, *Effective Marginal Tax Rates on Low-Income Households*, 84 TAX NOTES 1191, 1193 (1999) (showing that taking accrued benefits into account, the "net" tax is somewhat lower than expected).

they pay to their employees by the full amount of payroll taxes they are required to pay.[76] This depends on the relative elasticity of supply and demand for the waiter's labor, which in the case of payroll taxes was found to shift the entire tax burden to the employees.

Similarly, the amount of tax evaded, that is, the money saved by the taxpayer due to the tax evasion, will be shared by the waiter and the restaurant according to the relative elasticity of supply and demand for the waiter's labor. In the above example I assumed that the tax evaded is pocketed by the waiter. In reality, the waiters and their employers share in the amount evaded. The reason it is shared is that the amount evaded increases the after-tax wages paid to employees, allowing the restaurant owners to reduce their pay.

The restaurant and the waiter share the tax evasion according to the relative elasticities of supply and demand for the waiter's labor. If demand is relatively more elastic, the restaurant will lower the wages paid to the waiter by an amount that is close to the amount evaded, so that the waiter gains very little by evading the tax. If supply is relatively more elastic, the tax that was not paid to the government increases the waiter's after-tax income. Plausibly, the actual division is somewhere in between.

In the case that tip income by itself, that is when no other wages are paid, is higher than the market wage for waiters, the employer may find ways to take some of the tip income away from the waiter. This may be done by forcing the waiters to share their tip income with other employees, such as busboys, thus saving the employer the cost of paying full salaries to those other employees. The employer may even charge the employees for the right to work at the restaurant and earn tips.

A. Tax Enforcement

Employees who receive wages in the form of tips are required to report the amount of the tips they receive to their employer, who must send copies of these reports to the IRS.[77] The problem, however, is that like any other cash income, it is impossible for the IRS to know the exact amount of tips paid in cash, because there is no written or electronic evidence of such amounts. It is in fact an "honor system" by which the waiter is supposed to declare the income to his employer.

The IRS uses presumptive tax methods to overcome its disadvantage in relying on waiters to report their cash tip income. Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ

76. *See id.* at 1193 ("Economists generally agree that the employer's share of these payroll taxes is borne by the worker as a matter of economic incidence.").

77. 26 C.F.R. § 31.6011(a)-1(a) (2006).

from the usual rules based on the taxpayer's accounts. The term "presumptive" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method.[78] In the case of tips, the presumption may be rebutted if the taxpayer demonstrates that the government's calculation in the particular case has likely produced an inaccurate result.[79]

The use of presumptions to tax waiter's tip income was first approved by the courts in the context of income taxes. In *Mendelson v. Commissioner*,[80] the Court interpreted 26 U.S.C. § 446(b),[81] to authorize the IRS to use methods of estimation for determining income tax liability. The IRS based its estimate of the tip income of an individual waitress on the restaurant's gross receipts and average tips earned by all waitresses employed by the restaurant.[82] In *McQuatters v. Commissioner*,[83] the formula was perfected and this method of presumptive tax calculation has been known since then as the "McQuatters Formula."[84]

The McQuatters Formula works as follows: (1) the total sales of the restaurant are reduced by a percentage to account for sharing tips and for customers who leave little or no tip; (2) the resulting amount is divided by the total number of hours worked by all servers during the year to determine a sales-per-hour average; (3) that average is multiplied by the number of hours worked by each server to determine the server's yearly sales; and (4) the yearly sales of each server are multiplied by an average tip rate to determine the yearly tip income of each server. The formula uses the charged tip rate (i.e., the tip rate computed on bills charged by

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78. Victor Thuronyi, *Presumptive Taxation*, *in* 1 TAX LAW DESIGN AND DRAFTING (Victor Thuronyi ed., 1996).

79. United States v. Fior D'Italia, Inc., 536 U.S. 238, 247-48 (2002).

80. 305 F.2d 519 (7th Cir. 1962).

81. I.R.C. § 446(b) (2006) ("The computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.").

82. Mendelson, 305 F.2d at 521-522. The method was described by the court as follows:

> First, ascertain the total of the total food sales and the sales of liquor served at tables during the respective years. Second, divide the totals for the respective years by the total number of hours worked by all waitresses as waitresses during the respective years to ascertain the average amount of food and liquor served per average waitress hour. Third, multiply the quotients thus obtained for the respective years by the number of hours the petitioner worked as waitress during such years to ascertain the total amount of food and liquor served by petitioner during each year. Finally, apply twelve percent to the total sales of food and liquor served by petitioner as thus ascertained so as to ascertain the amount of the petitioner's taxable tips for the respective years.

Id.

83. McQuatters v. Comm'r, 32 T.C.M. (CCH) 1122 (1973).

84. *See, e.g.*, Bubble Room, Inc. v. United States, 159 F.3d 553 (Fed. Cir. 1998).

customers to credit cards) as a reference point for the average tip rate.[85]

The use of presumptive taxation for FICA taxes was introduced only much later, and only with regard to the employer's share of the FICA taxes. Instead of auditing individual waiters, the IRS audited employers, basing its assessment upon its aggregate estimate of all the tips that the restaurant's customers paid its employees. In doing so, it relied on its general authority in section 6201(a) of the IRC "to make the inquiries, determinations, and assessments of all taxes . . . which have not been duly paid." Auditing the employer and computing the tips that its employees have allegedly received in the aggregate saves the IRS significant costs incurred by auditing each individual employee.

The IRS used a simplified (inflated) version of the McQuatters Formula for FICA tax purposes.[86] It determined the average percentage tip on the restaurant's credit card sales; assumed the same percentage for cash sales; multiplied the credit card tip percentage by total receipts; and subtracted the total tips already reported by the employees. It then charged the employer with FICA taxes on the resulting amount.

This form of presumptive taxation was challenged in several courts with different results, and was finally approved by the Supreme Court in the 2002 landmark case, *Fior D'Italia, Inc. v. United States*.[87] In the opening section of the majority opinion, the Court defined the question it had to decide, as follows:

> We must decide whether the law authorizes the Internal Revenue Service (IRS) to base that assessment upon its *aggregate estimate* of all the tips that the restaurant's customers paid its employees, or whether the law requires the IRS instead to determine total tip income by estimating each *individual employee's* tip income separately, then adding individual estimates together to create a total.[88]

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85. *McQuatters*, 32 T.C.M. (CCH) at 1125.

86. United States v. Fior D'Italia, Inc., 536 U.S. 238, 247 (2002). Holding:

> An aggregate calculation based on credit card slips can overstate the aggregate amount of tips because it fails to account for the possibilities that: (1) customers who pay cash tend to leave a lower percentage of the bill as a tip; (2) some customers "stiff" the waiter, leaving no tip at all; (3) some customers write a high tip on the credit card slip, but ask for some cash back, leaving a net lower amount; and (4) some restaurants deduct the credit card company fee from the tip, leaving the employees with a lower net amount.)

Id. at 247. Moreover, FICA taxes may be applied only to income that falls within the 'wage band'. The wage band does not include tips paid to waiters who earned less than twenty dollars per month in tips, and does not include income above a certain level, $92,400 in 2006. *Id.*

87. 536 U.S. 238 (2002).

88. *Id.* at 240.

Framing the question in this way; that is, choosing the words "aggregate" and "individual" assessments is imperfect as it draws attention away from the main issues that were actually decided in the case. Because even if the IRS first estimated each individual employee's tip income separately and only then added the estimates together to create a total, the same questions would arise, assuming that the individual estimates[89] were based on presumptive taxation.[90]

The real question was therefore the authority to "estimate," namely, to use presumptive taxation. The IRS authority to do so had already been approved in the context of income tax, but doing so in the context of FICA taxes raised, in addition to difficulties in statutory interpretation, the following two questions of substance:

1. Can the IRS charge the employer with his share of the FICA taxes without crediting the employees' social security accounts for the taxes paid?

The employer's FICA tax can be viewed as paid on behalf of the employees because, according to conventional wisdom, employees bear the economic burden of the employer's share of FICA taxes. The formal, equal, division of the tax between employers and employees is done for symbolic reasons only. It has nothing to do with the economic reality. So it is in fact the employees who bear the burden of the FICA tax imposed on their employer. FICA taxes are different from income taxes, they are supposed to fund Social Security benefits. The payments that beneficiaries are entitled to receive are determined by the records of their wages earned.[91] Usually there is a link between the wages and the FICA taxes. Each employee is given, in essence, credit for the amount of tax she paid and for the amount of tax paid by her employer on her behalf. If the wages were found to be higher than reported, thereby resulting in additional FICA taxes (paid by the employer), this should be reflected in the employees' records for Social Security benefits, because the economic reality is such that FICA taxes paid by employers are paid on behalf of their employees.

On the other hand, 26 U.S.C. §45B provides an income tax credit to an

89. The Court uses the term "estimate" (namely, presumptive taxation) in the aggregate as well as in the individual context.

90. The Internal Revenue Service could simply add another (redundant) step to its calculation. It could determine the average percentage tip on the restaurant's credit card sales, as it did before: assume the same percentage for cash sales, as it did before; multiply total sales by the number of hours worked by each server divided by the number of hours worked by all servers; multiply the resulting amount by the average tip rate to determine the yearly tip income of each server; add the individual estimates together to create a total; and subtract the total tips already reported by the employees, as it did before.

91. Flemming v. Nestor, 363 U.S. 603, 608 (1960).

employer for employer FICA taxes paid with respect to employee tips. The amount of the credit equals an employer's FICA tax payments attributable to tips in excess of those treated as wages for the minimum wage requirements of the Fair Labor Standards Act (FLSA).[92]

Section 45B creates a peculiar scheme, because except in cases where restaurants do not have taxable income, the Treasury will hardly collect any revenue from imposing employer FICA taxes on wages. Whatever is paid by employers to the Social Security trust fund is returned to the employer through income tax credit. The employees are not likely to be burdened by the tax either, because if their employer is not burdened by it, it will not be shifted to the employees. This seems like a transfer from general revenue collected by the income tax to the Social Security trust fund, using the employers as unnecessary middlemen. Such a transfer involves wasteful transaction costs.

If that is indeed the case, then employer FICA taxes hardly burden employers or employees, and it is difficult to understand why restaurants such as Fior D'Italia incurred the cost of what must have been very expensive litigation.

There is nothing in *Fior D'Italia* that can help answer this question. The minority opinion briefly mentions the argument that there should be a link between taxes paid and benefits accrued, but does not develop the issue.[93] The majority opinion ignores the issue entirely. Neither opinion provides an answer to the puzzle caused by the existence of 26 U.S.C. §45B.

The Supreme Court in *Fior D'Italia* granted the Government's petition for certiorari, in light of differences among the Circuits on the question of IRS use of presumptive taxation to assess and collect FICA taxes from employers on unreported tip income. One of these Circuit Court decisions was *Bubble Room, Inc. v. United States*,[94] which dealt primarily with the issue of the link between taxes and Social Security benefits. The court in the *Bubble Room* case reversed a summary judgment granted by the Court of Federal Claims.[95] The Court of Federal Claims had concluded that the aggregate tax assessment against the Bubble Room restaurant was illegal because the IRS did not credit the Social Security earnings records

92. As will be discussed in detail below, the Fair Labor Standards Act allows an employer to pay less than the minimum wage directly to a tipped employee by treating tips received by the employee as satisfying a portion of the statutory minimum wage. 29 U.S.C. 203(m) (2000). *See also*, 29 C.F.R. § 531.59 (defining the Tip Wage Credit); Kilgore v. Outback Steakhouse of Flordia, Inc., 160 F.3d 294, 298 (6th Cir. 1998) (finding that hosts were tipped employees whose wages employers could count as tip wages towards meeting the minimum wage requirement).

93. *Fior D'Italia, Inc.*, 536 U.S. at 254 (2002).

94. 159 F.3d 553 (Fed. Cir. 1998).

95. *Id.* at 565

of each of the Bubble Room's tipped employees.[96] The Circuit Court reversed this decision stating: "We are convinced that, when an employee fails to report tips received, neither the employee nor the employer can then complain that the employer's share of FICA taxes is not credited to the employee's wage history account."[97] By ignoring the issue of the link between taxes and Social Security benefits, the Supreme Court, in *Fior D'Italia*, has implicitly embraced a similar view.

2. Can the IRS Use a Presumption to Tax the Employer When the Employer, Unlike the Employees, Does Not Have Access to the Data Necessary to Rebut the Estimate In Case It Was Inflated?

The Tax Code imposes a general obligation upon all taxpayers to keep records relevant to their liability, according to regulations promulgated by the Secretary.[98] A taxpayer who fails to attend to this regulation has only himself to blame.[99] However, 26 U.S.C. § 6001 expressly excuses employers from the obligation to ensure that their employees are properly reporting their tips.[100]

According to the minority opinion in *Fior D'Italia*, the "[c]ode tells them that they need not keep the information specific to each employee that would be necessary to determine if any tips fell short of the estimates or outside the wage band."[101] Hence, while in income tax cases, such as *Mendelson* and *McQuatters* the presumption was used against the individual employees who are obligated to keep records, in the FICA context it was used against the employer, who are not obligated to keep such records.

There is a crucial difference between the majority and minority opinions in *Fior D'Italia*. They require different evidence for an employer to demonstrate that presumptive taxation led to an inaccurate result in his

96. Bubble Room v. United States, 36 Fed. Cl. 659, 672 (1996).

97. *Bubble Room*, 159 F.3d at 565.

98. 26 U.S.C. § 6001 (2000).

99. *See, e.g.*, Kikalos v. Comm'r, 190 F.3d 791, 792, n.1 (7th Cir. 1999) (describing how the Tax Commissioner evaluated the plaintiffs' income based on their bank deposits, because they did not have documentation of their cash based income); Cracchiola v. Comm'r, 643 F.2d 1383, 1385 (9th Cir. 1981) (rejecting petitioners' argument that 26 U.S.C. § 6001 is void for vagueness and violates the thirteenth amendment); Meneguzzo v. Comm'r, 43 T.C. 824, 831 (1965) (holding that if the plaintiff did not properly document his income, the Commissioner of Internal Revenue is authorized to compute the taxpayer's income according to what he or she deems an appropriate method).

100. 26 U.S.C. § 6001 (2000) ("The only records which an employer shall be required to keep under this section in connection with charged tips shall be charge receipts, records necessary to comply with section 6053(c), and copies of statements furnished by employees under section 6053(a).").

101. 536 U.S. 238, 256 (2002).

or her particular case. According to the minority opinion, "the only way an employer can refute probable inflation by estimate is to keep track of every employee's tips."[102] According to the majority, however, employers need only "demonstrate that use of the aggregate method in the particular case has likely produced an inaccurate result. And in doing so, it may well be able to convince a judge to insist upon a more accurate formula."[103]

In sum, the use of presumptive taxation to assess and collect taxes on unreported tip income has the general advantages and disadvantages that one would expect of any presumptive tax method. On one hand, it overcomes the massive problem of evasion. On the other hand, presumptive taxation is inherently unfair. It is based on averages and, therefore, waiters and waitresses whose tip income are lower than the average are subject to higher tax rates than their fellow waiters and waitresses. In addition, if the assessment is inflated, taxpayers may find it difficult to rebut it for lack of evidence. Also, although the servers pay these taxes, they do not accrue Social Security benefits. However, by failing to report the tips as wages, the employees may be viewed as waiving their rights to be treated like law-abiding taxpayers.

So long as it is assumed that employees bear the economic burden of the FICA tax paid by their employers (or alternatively assume that, as according to section 45B, no one does) employers are not in a position to complain either. Employers are better off when their employees evade taxes, because this allows the employers to pay them lower wages. It means that they share in the tax savings according to the relative elasticity of supply and demand for labor. Therefore, employers should not be allowed to rely on section 6001, excluding them from the need to monitor their employees' tips to ensure accurate reporting, to argue that the IRS has no authority to tax them on a presumptive basis.

B. Employment Law

Department of Labor regulations define a 'tip' as "a sum presented by a customer as a gift or gratuity in recognition of some service performed for him. It is to be distinguished from payment of a charge, if any, made for the service. Whether a tip is to be given, and its amount, are matters determined solely by the customer, and generally he has the right to

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102. *Id.* at 255.

103. *Id.* at 248. Employers can be expected to know information such as: The number of employees that are likely to earn "less than $20 in tips; how many employees were likely to have earned more than $55,000 or so in 1992; how much less cash-paying customers tip; how often they "stiff" waiters or ask for a cash refund; and whether the restaurant owner deducts a credit card charge of, say 3%, from employee tips?" *Id.*

determine who shall be the recipient of his gratuity."[104]

The regulations distinguish a tip from a "service charge" stating that: "A compulsory charge for service, such as 10 percent of the amount of the bill, imposed on a customer by an employer's establishment, is not a tip, even if distributed by the employer to his employees."[105]

The above definitions are confusing. First, they use the term "gift" instead of payment. A gift is given outside the context of a business transaction, whereas a tip is given to a waitress in recognition of the service she provided to the customer as part of the business transaction of buying a meal. The only resemblance between a tip and a gift is that the amount in both cases is left to the discretion of the person who pays.

Second, the above definitions give the false impression that a customer can decide (indeed, "ha[s] the right to determine") that the money he or she leaves on the table will be the waiter's property.[106] Usually, employers allow employees to keep the tip for themselves. Otherwise, there would be no difference between a service charge and a tip from the employee's point of view.

It is important, however, to decide who owns the tip in the first place. If it is the waiter who owns the tips, then tips are not "wages," and, hence, cannot be counted towards the statutory obligation to pay the minimum wage. Moreover, no FICA taxes need to be paid, neither by the employee nor by the employer, and the employer is not required to pay sales tax on the tip income.

Under federal law, it is the employer, not the customer, who has the right (namely, the legal power) to determine who shall have ownership of the money. The tip will be the property of the waiter only if the employer so authorized in the employment agreement and this must be done *before* the tip is given.[107] And indeed, "tips received by an employee in the course of his employment shall be considered remuneration . . . and deemed to

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104. 29 C.F.R. § 531.52 (2005) (describing the general characteristics of tips).

105. *Id.* § 531.55 (2005) (describing examples of amounts not received as tips).

106. 29 C.F.R § 531.52 (2005).

107. The definition is confusing (a "tip" is defined as money paid at the customer's discretion, but a "tipped employee" is not someone who received a tip, but only someone who may keep it), but is nevertheless accurate. It explicitly says that

> [i]n the absence of an agreement to the contrary between the recipient and a third party, a tip becomes the property of the person in recognition of whose service it is presented by the customer. Only tips actually received by an employee as money belonging to him which he may use as he chooses free of any control by the employer, may be counted in determining whether he is a 'tipped employee' within the meaning of the Act and in applying the provisions of section 3(m) which govern wage credits for tips.

Id. § 531.52.

have been paid by the employer for purposes of [the FICA taxes]"[108] as discussed above..

As tips are part of the wage deemed to have been paid by the employer, then they should be considered as such for the purpose of minimum wage law. An employer should be allowed to consider tips as part of the wages she pays her employees, and should not be required to pay an employee if that employee's income, including tips, is above the minimum wage threshold.

The FLSA[109] allows employers of tipped employees (defined as employees who customarily and regularly receive more than $30 a month in tips)[110] to consider such tips as part of their wages, but, nevertheless, requires employers to pay a direct wage of at least $2.13 per hour, irrespective of the employee's income from tips. The combined amount of tips and direct pay must equal or exceed the minimum wage of $5.15 per hour. The difference between the minimum wage of $5.15 and the required direct wages of $2.13 is called the "tip credit," and only such tips are treated as wages paid by the employer for satisfaction of the minimum wage requirement.[111] State laws, in California for example, are often even more demanding of employers and disallow any consideration of tip income for minimum wage purposes.[112] They do not view the tip income as wages paid by the employer at all.

In order to use the tip credit, the employer must allow the tipped employee to retain all tips, except if the employee participates in a valid tip pooling arrangement.[113] FLSA forbids any arrangement between the employer and the tipped employee whereby any part of the tip received becomes the property of the employer. A tip is the sole property of the tipped employee. Where an employer does not strictly observe the tip credit provisions of the Act, no tip credit may be claimed and the

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108. I.R.C. § 3121(q) (2000).

109. 29 U.S.C. §§ 201-219 (2000).

110. *Id.* at §§ 203(t) (2000)

111. 29 CFR § 531.60 (2005) (describing how tipped employees who receive $2.13 per hour in direct wages are entitled by law to overtime (time-and-a-half) based on $5.15 minimum wage, not the $2.13 direct wage).

112. *See* CAL. [Labor] CODE §351 (2003) (denying employers the ability to use a tip credit).

113. *See* U.S. Department of Labor, Fact Sheet No. 15: Tipped Employees Under the Fair Labor Standards Act (FLSA), http://www.dol.gov/esa/regs/compliance/whd/whdfs15.htm (last visited Aug. 16, 2006) ("Employers may set up tip splitting or pooling arrangements among employees who customarily and regularly receive tips, such as waiters, waitresses, bellhops, counter personnel (who serve customers), busboys/girls, and service bartenders. . . . Only those tips that are in excess of tips used for the tip credit may be taken for a pool. Tipped employees cannot be required to contribute a greater percentage of their tips than is customary and reasonable.").

employees are entitled to receive the full cash minimum wage. Additionally, they retain tips they may or should have received.[114]

The employer has the responsibility to ensure that her employees earn at least the minimum wage. When tips are considered part of the remuneration, they should be taken into consideration in full. If minimum wage is viewed to be too low, there is no reason to increase it only with respect to tipped employees, and in a way that depends on their income from tips. It should be raised explicitly to benefit all poorly-paid employees, and should not be limited to employees who happen to receive tips.

FLSA reflects conflicting views regarding the question of who owns the tip in the first place, and offers a peculiar compromise. Employers receive credit for the tip for minimum wage purposes, because it is considered "wages", but they do not get it in full. They are still required to pay $2.13 per hour and are required to allow the waiters to keep the entire tip. At the same time, the tip is considered "wages" for tax law purposes. FLSA allows employers to receive an income tax credit for employees' FICA tax payments attributable to tips in excess of those treated as wages for the minimum wage requirements. All this is quite confusing and does not seem to promote any clear policy goal.

The conflicting views regarding tip ownership are not confined to the federal level. California, for example, has a tipping statute based on the view that the tip is the sole property of the waiter.[115] Section 351 of the California Labor Code states:

> No employer or agent shall collect, take, or receive any gratuity or a part thereof that is paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of a gratuity, or require an employee to credit the amount, or any part thereof, of a gratuity against and as a part of the wages due the employee from the employer. Every gratuity is hereby declared to be the sole property of the employee or employees to whom it was paid, given, or left for.[116]

The question of tip ownership raised similar conflicting views in other countries as well. In Europe, for example, the question was decided by the European Court of Human Rights in 2002 in *Nerva v. United Kingdom*.[117] English waiters argued that a British High Court judgment deprived them of the peaceful enjoyment of their possessions. They complained that

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114. *Id.*

115. Whereas tips are the property of the waiter in the first place, employers in California cannot consider tips as payment for minimum wage purposes. CAL. [Labor] CODE §351 (2003).

116. *Id.*

117. 8 Eur. Ct. H.R. 3 (2002).

money which was left for them as tips by customers passed to their employer to be used as she wished and, in their case, discharged the employer's statutory obligation to pay them a minimum wage.

The case discusses only tips paid through credit cards and checks. The British restaurant did not consider tips paid in cash as its own. Consequently, they could not be used towards fulfilling the employer's obligation to pay minimum wage. The European Court of Human Rights held that there was no breach.

The court argued that ownership of tips through checks and credit cards first passes to the employer, simply because vouchers signed by customers are made out in the employer's name and are cleared through the latter's account.[118] The wait staff then receives the tips as wages.

European law thus also makes a senseless compromise, albeit of a different kind. It distinguishes between tips paid in cash and those paid by check or credit card, thereby pointlessly allowing the form of payment to decide the question of who owns the tip.

The view expressed by the dissenting Justice in *Nerva* is probably shared by the California legislature, and by all others who view the tips as the property of the waiter. The Justice stated "I believe that the applicants must be taken to have had a property right with respect to the tips: a right derived from the intention of the customers and the role of the employer in ensuring that that intention was respected."[119] According to this view, the tips are entrusted by the customers to the employer with the express or implied intention that they will be specifically handed over in full to the employees. Hence, the tips become the "possessions" of the employees in the first place.

The customer's intent is completely irrelevant. The waiter is an employee and received the tip for acting in his capacity as an employee. The restaurant offers its customers a bundle of goods and services. Customers pay restaurants to hire cooks, busboys, and waiters. The waiter or waitress cannot provide services to the customer simultaneously as a paid employee and as a self-employed individual. He or she, therefore, renders services only as an employee, no matter how much effort he puts into his work. When the customer pays the waiter he is paying him for the service component of the bundle she received. This is not a gift, as it is given in connection with the service. The waiter is paid because he provides a service in his capacity as a restaurant employee. The customer's intent cannot create the fiction that the waiter performed more than one service job at the same time: as an employee providing regular service and earning wages and as a self-employed individual earning tip income.

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118. *Id.* at 16.
119. *Id.* at 17.

Treating tips as wages for tax as well as for labor and employment law purposes will simplify the laws and may help to fight tax evasion. Under the current law, post-*Fior D'Italia*, the IRS audits employers and collects employers' FICA taxes, but employee FICA taxes and income tax are still audited on an individual basis. Such auditing involves high costs and is therefore rare. Viewing the tips as the restaurant's income, as suggested in this paper, will significantly simplify tax enforcement. Restaurants will pay income taxes as well as sales taxes on the service component of the meal, even if paid as a tip.

Whatever the employer pays the wait staff, whether or not based on tips received, will be deducted as payment of wages for the employer's income tax purposes. It will be taxed as wage income to the employees. Consequently, employer and employee FICA and FUTA taxes will be paid. Employees will be entitled to Social Security benefits calculated on the basis of their full wages, including the amounts related to tips.

V. CONCLUSION

Returning to the question posed in the Introduction: is it good that upscale New York City restaurants are considering replacing tips with a service charge?

As argued in this paper, such a move would benefit society, but would also potentially be detrimental to the restaurant. Restaurants would not want a service charge based system that reduces their workers' income by eliminating their ability to evade taxes.

The upscale New York restaurants could be reacting to *Fior D'Italia*, which increased the risk of the IRS taxing employers according to an inflated formula. The formula does not provide clear guidance as to what an employer would be required to prove to demonstrate its inaccuracy.

In addition, there is a reason why this phenomenon is only taking place in upscale restaurants. In such restaurants prices are high and the tips are huge because, as discussed in Part II above, tips mainly depend on the size of the bill and not on the service.[120] When tax evasion possibilities are limited, there is no reason for the owner of the restaurant to pay such high amounts to his wait staff. He can collect the money that customers pay for service, pay the waiters high salaries, and keep the difference.

The restaurant could retain the service fee by asking the waiters to hand over their tips. But this is not the norm, and may demoralize the waiters. In some states, such as California, it is even illegal. Therefore, the

120. *See* POST, *supra* note 6, at 532 (explaining that tips in upscale restaurants tend to be higher, not only in absolute value, but also in percentage of the bill, than those in cheaper restaurants).

restaurant is better off switching to a service charge.

However, this is worthwhile only for upscale restaurants where the prices that customers pay for their meals are high enough to allow a surplus after wages paid to the employee are increased, wages high enough to attract high-quality waiters, and the employers are additionally taxed. Most restaurants are unlikely to make such a move, and that is why judicial or legislative intervention is necessary and would be welfare-maximizing.

A mandated switch to a service charge will not only reduce opportunities for discrimination, as suggested by Ayres et al., but may also significantly improve tax compliance.[121]

If such regulation does not take place, courts can enhance welfare if they adopt the analysis that this paper suggests, and view tips as income of the restaurant. Hence, courts would treat tips according to their true nature: payment for the service component of the meal. This will significantly simplify tax enforcement and reestablish the link between taxes paid and benefits received. Consequently, this new strategy will improve employees' financial security in the long run. The social cost, in terms of relinquishing tipping as a service-quality monitoring device, will likely be miniscule.

121. Customers may tip even if they know that they have already been charged for the service, but the amounts of the tips are likely to be very small.