DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: August 27, 2008
Decision: MTHO # 431
Taxpayer: ***ABC Taxpayer***
Tax Collector: City of Phoenix
Hearing Date: June 12, 2008

DISCUSSION

Introduction

On March 27, 2008, ***ABC Taxpayer*** ("Taxpayer") filed a protest of a tax assessment made by the City of Phoenix ("City"). After review, the City concluded on April 4, 2008 that the protest was timely and in the proper form. On April 10, 2008, the Municipal Tax Hearing Officer ("Hearing Officer") ordered the City to file a response to the protest on or before May 26, 2008. On April 22, 2008, the City filed a response to the protest. On April 24, 2008, the Hearing Officer ordered Taxpayer to file any reply on or before May 15, 2008. On May 14, 2008, a Notice of Tax Hearing ("Notice") scheduled the matter for hearing commencing on June 11, 2008. On May 15, 2008, Taxpayer filed a reply. On May 20, 2008, a Notice rescheduled the hearing to commence on June 12, 2008. Both parties appeared and presented evidence at the June 12, 2008 hearing. On June 16, 2008, the Hearing Officer indicated that the parties had agreed to the following schedule: Taxpayer would file an opening brief on or before June 27, 2008; the City would file a response brief on or before July 11, 2008; and, Taxpayer would file a reply brief on or before July 18, 2008. Taxpayer filed an opening brief on June 26, 2008. The City filed a response brief on July 10, 2008. Taxpayer filed a reply brief on July 18, 2008. On July 21, 2008, the Hearing Officer indicated the record was closed and a written decision would be issued on or before September 4, 2008.

City Position

The City conducted an audit of Taxpayer for the period January 2003 through June 2006. Taxpayer was in the restaurant and bar business. The City assessed Taxpayer for additional taxes due in the amount of $5,310.97, plus interest up through January 2008 in the amount of $1,274.92. The City's assessment resulted from the inclusion of credit card gratuities in Taxpayer's gross income. The City noted that City Regulation 14-455.1(2) ("Regulation 455") requires two contingent requirements to be satisfied so gratuities are not deemed as a taxable part of income. The first requirement is that gratuity charges are to be stated separately on a customer's bill or invoice. The second requirement is for gratuities to be distributed in total to the employees by the taxpayer.

The City argued that Taxpayer did not meet the second requirement for gratuities. The City asserted that Taxpayer required its employees to forfeit three percent of all credit card gratuities to Taxpayer. According to the City, Taxpayer utilized the three percent amount to help pay for credit card processing fees. The City indicated they had requested the source documents for "credit card fees from tips" from Taxpayer. The City asserted the source documents were not provided and as a result the City had to estimate the total credit card gratuities based on the "credit card fee tip" figures from Taxpayer's profit and loss statements. The estimate was calculated based on Taxpayer taking three percent of the gratuities. The City noted that it was authorized to use an estimate pursuant to City Code Section 14-555(e) ("Section 555"). The City asserted that City Code Section 14-545(b) ("Section 545") places the burden on Taxpayer to prove the estimate is not reasonable.

The City opined that Taxpayer used to pay its waiters and waitresses in cash for the exact amount of tips left on credit cards. According to the City, Taxpayer began to notice that more and more of its customers were paying by credit cards, as opposed to cash. Based on the hearing testimony, the City concluded that Taxpayer wanted its employees to share some or all of the costs associated with credit card transactions. As a result, the City opined Taxpayer gave its employees the option of waiting until the credit card charge was shown to be valid in order to receive the full amount of the tip or the employee could return three percent of the tip which allowed the employee to receive the tip on the same day it was charged on the customer's credit card.

The City disputed Taxpayer's referral of the agreement with its employees as a voluntary action. The City argued that a person's agreement to select from two offered choices does not make the decision voluntary. According to the City, the employees were given two alternatives and they simply selected the less objectionable of the two. While Taxpayer has argued the employees received one hundred percent of the credit card tips, the City disputed that argument. The City asserted the substance of the transaction is that the employee receives ninety seven percent of the tips and Taxpayer receives three percent of the tips.

Taxpayer Position

Taxpayer protested the City's assessment on the income paid to and received by Taxpayer's service employees (i.e., waiters, waitresses, bus-boys, etc.). Taxpayer argued that the City's conclusion that the credit card gratuities were not distributed in total to the employees was an erroneous conclusion. Taxpayer asserted that the employees received one hundred percent of the credit card gratuity in cash. According to Taxpayer, that satisfies the requirements of Regulation 455 and the gratuities should be excluded from Taxpayer's gross income.

Taxpayer noted that there was a voluntary agreement in place whereby service employees expended three percent of their credit card tip monies in order to receive their gratuities

each night instead of waiting for payment from the credit card company. According to Taxpayer, this is no different than an employee using some of its cash gratuity monies to pay for a "running tab" at the restaurant. Taxpayer asserted that the City did not dispute that cash gratuities were exempted from taxation to Taxpayer because they were distributed in total to the employees. Taxpayer argued that the City's treatment of "cash-cash" tips was not consistent with the City's treatment of "credit-cash" tips. Taxpayer opined that if a "cash-cash" tip was used to satisfy a previously agreed upon running tab bill, the City would exempt the income from the restaurant's gross income. Taxpayer asserted there can be no rational basis for tax discrimination or differentiating between the tips distributed in total whether "cash-cash" or "credit-cash". Based on the above, Taxpayer requested the assessment on the "credit-cash" tips to be abated in full.

ANALYSIS

Taxpayer initially paid out and its employees kept one hundred percent of their tips. Over a period of time, the number of customers paying by credit cards increased substantially. This resulted in Taxpayer subsidizing the employees for their tips since Taxpayer had to pay a percentage of the tips to the credit card company. As a result, Taxpayer had a meeting with its employees and gave them the option of receiving one hundred percent of the credit card gratuities after being completely processed by the credit card company or the employee could pay Taxpayer three percent of the gratuity in order to receive the gratuity on the same day the customer authorized a gratuity.

All of the employees chose to be paid the gratuity on the same day it was authorized by the customers. Based on the evidence, the employees received at the end of their shifts one hundred percent of their gratuities. Pursuant to the agreement between Taxpayer and their employees, the employee then had to reimburse Taxpayer for the three percent amount for the privilege of receiving same day gratuities. We believe the parties are generally in agreement to the facts we have set forth herein.

The dispute revolves around whether Taxpayer may exclude employee gratuities from its gross income pursuant to Regulation 455.1. There are several requirements set forth in Regulation 455.1 that must be met by Taxpayer in order to exclude gratuities from its income. The only requirement disputed was whether or not the gratuities were distributed in total by Taxpayer to its employees. Clearly, the employees are initially given one hundred percent of the gratuities. It is also clear that at the same time the employee has an obligation pursuant to the agreement with Taxpayer to return three percent of that gratuity. Taxpayer had argued this is similar to employees being obligated to pay for "on going tabs." We must disagree with that argument. There is simply no direct connection to cash gratuities and "on going tabs." There is not even a requirement for the employee to have an "on going tab." If an employee chooses to have such a tab, the employee has the freedom to pay for the tab with whatever monies he or she chooses and certainly it doesn't have to be gratuity money. If in this case, Taxpayer had kept three percent of the credit card gratuities and "distributed" the remaining ninety-seven percent to the employee, there would be no doubt that Taxpayer failed to meet requirements of one

hundred percent "distribution" set forth in Regulation 455.1. Is that result changed if one hundred percent of the gratuities are distributed and one minute later (or however long) three percent is paid back to Taxpayer pursuant to their agreement? We think not. While Taxpayer has referred to the three percent amount as voluntary, we must disagree. Pursuant to the agreement with Taxpayer, the employees are obligated to pay back three percent of the gratuities for the right to receive the gratuities on the same day the gratuities were set forth on the customer's charge card bill. As a result, we find one hundred percent of the charge card gratuities were given to the employees with the understanding/obligation that three percent was to be paced in a jar/container of Taxpayer for use solely by Taxpayer. Accordingly, we conclude there was a ninety-seven percent distribution of credit card tips to the employees. We further conclude that Taxpayer has failed to meet its burden of proof pursuant to City Code Section 360 ("Section 360") and Regulation 455.1. Based on all the above, Taxpayer's protest should be denied.

FINDINGS OF FACT

1. On March 27, 2008, Taxpayer filed a protest of a tax assessment made by the City.

2. After review, the City concluded on April 4, 2008, that the protest was timely and in the proper form.

3. On April 10, 2008, the Hearing Officer ordered the City to file a response to the protest on or before May 26, 2008.

4. On April 22, 2008, the City filed a response to the protest.

5. On April 24, 2008, the Hearing Officer ordered Taxpayer to file any reply on or before May 15, 2008.

6. On May 14, 2008, a Notice scheduled a hearing to commence on June 11, 2008.

7. On May 15, 2008, Taxpayer filed a reply.

8. On May 20, 2008, a Notice rescheduled the hearing to commence on June 12, 2008.

9. Both parties appeared and presented evidence at the June 12, 2008 hearing.

10. On June 16, 2008, the Hearing Officer indicated the parties agreed to the following schedule: Taxpayer would file an opening brief on or before June 27, 2008; the City would file a response brief on or before July 27, 2008; the City would file a response brief on or before July 11, 2008; and, Taxpayer would file a reply brief on or before July 18, 2008.

11. Taxpayer filed an opening brief on June 26, 2008.

12. The City filed a response brief on July 10, 2008.

13. Taxpayer filed a reply brief on July 18, 2008.

14. On July 21, 2008, the Hearing Officer indicated the record was closed and a written decision would be issued on or before September 4, 2008.

15. The City audited Taxpayer for the period January 2003 through June 2006.

16. Taxpayer was in the restaurant and bar business.

17. The City assessed Taxpayer for taxes in the amount of $5,310.97 plus interest up through January 2008 in the amount of $1,274.92.

18. The assessment resulted primarily from the inclusion of employee credit card gratuities in the Taxpayer's gross income.

19. The gratuities were separately stated on the customer's credit card bill.

20. Initially, Taxpayer simply passed through all gratuities to its employees.

21. As more and more of Taxpayer's customers paid with credit cards, Taxpayer entered into an agreement with its employees that required the employees to pay Taxpayer three percent of the gratuity if the employee wanted to receive the gratuity on the same day.

22. The employees had the option of receiving 100 percent of the gratuity if they waited until the credit card payment was processed.

23. The City did not include "cash-cash" gratuities as part of Taxpayer's gross income.

24. Taxpayer had a policy that allowed employees to "run a tab" at the restaurant and later pay the tab from employee personal monies including cash from gratuities.

CONCLUSIONS OF LAW

1. Pursuant to ARS Section 42-6056, the Municipal Tax Hearing Officer is to hear all reviews of petitions for hearing or redetermination under the Model City Tax Code.
2. During the audit period, Taxpayer was in the restaurant business pursuant to City

Code Section 455.

3. During the audit period, some of Taxpayer's customers separately charged gratuities on their credit card bills.

4. Taxpayer and its employees entered into an agreement whereby the employees would pay Taxpayer three percent of the credit card gratuities in exchange for the employees receiving the gratuities on the same day they were charged.

5. When an employee chose to receive the credit card gratuities on the same day they were charged, Taxpayer distributed ninety-seven percent of the gratuities to the employee and three percent was distributed to Taxpayer pursuant to the agreement between Taxpayer and its employees.

6. Taxpayer has failed to meet its burden of proof for an exclusion of credit card gratuities from Taxpayer's gross income pursuant to Section 360 and Regulation 455.1.

7. Taxpayer's protest should be denied.

ORDER

It is therefore ordered that the March 27, 2008 protest by ***ABC Taxpayer*** of a tax assessment by the City of Phoenix is hereby denied.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh
Municipal Tax Hearing Officer