

**Letter of Findings: 03-20170023
Withholding Tax
For the Years 2013 and 2014**

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Employer was responsible for state and county withholding taxes on wages, including tips, because tips were wages subject to income tax withholding. Employer was required to document and report that it properly deducted the taxes from the wages under its control or from the funds which were turned over by its employees.

ISSUE

I. Withholding Tax - Imposition.

Authority: I.R.C. § 451; I.R.C. § 3101; I.R.C. § 3102; I.R.C. § 3401; I.R.C. § 3402; I.R.C. § 6053; IC § 6-3-4-8; IC § 6-8.1-5-1; IC § 22-4-4-2; *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); Treas. Reg. § 31.3401(a)-1; Treas. Reg. § 31.3401(a)(16)-1; Treas. Reg. § 31.3401(f)-1; Treas. Reg. § 31.3402(k)-1; Treas. Reg. § 31.6053-1 *et. seq.*; [45 IAC 3.1-1-97](#); I.R.S. Publication 15; I.R.S. Publication 1244.

Taxpayer argues that the audit's adjustment of Indiana and county withholding tax was overstated because tips were not wages and it was not required to withhold income taxes on tips.

STATEMENT OF FACTS

Taxpayer is an out-of-state holding company. Beginning January 1, 2013, Taxpayer was in charge of payroll and withholding taxes on wages paid to employees who work at various dining establishments throughout the United States (including Indiana), which are managed by its affiliates. In addition to regular employees, Taxpayer also hires employees, such as waiters and waitresses, who receive tips from their customers when they serve their customers (hereinafter "tipped employees") at these dining establishments. Some of the employees, tipped employees or otherwise, who work in Indiana locations, are non-Indiana residents residing in states other than Indiana.

In 2016, the Indiana Department of Revenue ("Department") audited Taxpayer's business records and tax returns for state and county withholding taxes for the 2013 and 2014 tax years ("Tax Years at Issue"). Pursuant to the audit, the Department determined that Taxpayer failed to properly withhold taxes on wages paid to its employees. The audit assessed Taxpayer additional state and county withholding taxes for the Tax Years at Issue as a result.

Taxpayer timely protested the assessment, claiming that it was not responsible for a portion of the withholding taxes. A telephone hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings ensues and additional facts will be provided as necessary.

I. Withholding Tax - Imposition.

DISCUSSION

Pursuant to the audit, the Department determined that Taxpayer failed to properly withhold state and county tax from wages it paid to various employees for the Tax Years at Issue. Thus, the audit assessed additional state and county withholding taxes. In relevant part the audit noted:

1. [Taxpayer] employed several individuals who lived and worked in Indiana and no state or county adjusted gross income tax was withheld on their wages ([45 IAC 3.1-1-97](#));
2. [Taxpayer] also employed several individuals who lived in Illinois and worked in Indiana and [Taxpayer] withheld Illinois state income tax instead of Indiana state adjusted gross income tax [No Reciprocity Agreement with Illinois ([45 IAC 3.1-1-115](#))];
3. [Taxpayer] employed several individuals who lived outside Indiana and worked at various restaurants located within Indiana and [Taxpayer] did not withhold the non-resident county adjusted gross income tax from the employee's wages (IC [§] 6-3.5-1.1-1).

Taxpayer, to the contrary, claimed that it did "not owe the taxes being assessed when an employee had a zero net check." Specifically, Taxpayer did not protest the audit findings regarding its failure to properly withhold Indiana state or county income tax on wages paid to employees who were non-Indiana residents working in Indiana. Nor did Taxpayer protest the assessments on wages it paid to its tipped employees after claiming the "tip credit" under Indiana law. Rather, Taxpayer only protested the audit assessments on tip income which the tipped employees received from their customers and were required to be included in their W-2 (Wage and Tax Statement) forms. Thus, the issue is whether Taxpayer was responsible for withholding tax on tips which were required to be included as gross income for income withholding tax purposes in the tipped employees' W-2s for the Tax Years at Issue.

As a threshold issue, all tax assessments are *prima facie* evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). When an agency is charged with enforcing a statute, the courts defer to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

For federal withholding tax purposes, income tax is generally collected at the source unless specifically exempted. I.R.C. § 3402(a)(1) requires "every employer making payment of wages to deduct and withhold upon such wages a tax determined in accordance with prescribed tables" or a prescribed mathematical formula. Likewise, every employer is required to withhold state income tax on payments of wages it pays to its employees pursuant to IC § 6-3-4-8(a) (as in effect during the Tax Years at Issue), which states in part as follows:

Except as provided in subsection (d), every employer making payments of wages subject to tax under this article, regardless of the place where such payment is made, who is required under the provisions of the **Internal Revenue Code to withhold, collect, and pay over income tax on wages paid by such employer to such employee, shall, at the time of payment of such wages, deduct and retain therefrom the amount prescribed in withholding instructions issued by the department.** The department shall base its withholding instructions on the adjusted gross income tax rate for persons, on the total rates of any income taxes that the taxpayer is subject to under [IC 6-3.5](#), and on the total amount of exclusions the taxpayer is entitled to under [IC 6-3-1-3.5\(a\)\(3\)](#) and [IC 6-3-1-3.5\(a\)\(4\)](#). However, the withholding instructions on the adjusted gross income of a nonresident alien (as defined in Section 7701 of the Internal Revenue Code) are to be based on applying not more than one (1) withholding exclusion, regardless of the total number of exclusions that [IC 6-3-1-3.5\(a\)\(3\)](#) and [IC 6-3-1-3.5\(a\)\(4\)](#) permit the taxpayer to apply on the taxpayer's final return for the taxable year. Such employer making payments of any wages:

- (1) **shall be liable to the state of Indiana for the payment of the tax required to be deducted and withheld under this section** and shall not be liable to any individual for the amount deducted from the individual's wages and paid over in compliance or intended compliance with this section; and
- (2) shall make return of and payment to the department monthly of the amount of tax which under this article and [IC 6-3.5](#) the employer is required to withhold.

(Emphasis added).

IC § 6-3-4-8(a) requires an employer to "withhold, collect, and pay over income tax on wages paid by such employer to such employee . . . [in] the amount prescribed in withholding instructions issued by the department." IC § 6-3-4-8(a)(1) provides that the employer is "liable to the state of Indiana for the payment of the tax *required* to be deducted and withheld." (*Emphasis added*). IC § 6-3-4-8 specifically provides that the employer is liable for the amount that it was *required* to withhold.

[45 IAC 3.1-1-97](#) further explains in relevant part:

Employers who make payments of wages subject to the Adjusted Gross Income Tax Act, and who are required to withhold Federal taxes pursuant to the Internal Revenue Code (USC Title 26), **are required to withhold from employees' wages Adjusted Gross and County Adjusted Gross Income Tax. (Emphasis added).**

The employers are "withholding agents [who] . . . shall make return of and payment to the Department . . . tax due, for either County and State." *Id.* "All amounts deducted and withheld by an employer shall immediately upon deduction become the money of the State." *Id.* The regulation further states, "In the case of delinquency or nonpayment of withholding tax, the employer is liable for such tax, penalties, and interest." *Id.*

To state it differently, unless specifically exempted by statute, an employer is required to withhold state and county income tax from payments it pays to individual employees who reside and/or work in Indiana, including adopting or non-adopting county. The employer is responsible for the tax when it fails to do so as required by the above mentioned Indiana law.

Throughout its protest, Taxpayer argued that it was not responsible for the state and county withholding tax on tips because tips are excluded from the definition of "wages" pursuant to IC § 22-4-4-2, which references I.R.C. § 3102. In its January 6, 2017, protest letter, Taxpayer stated, in relevant part, as follows:

[U]nder federal law and in most states (including Indiana), employers may pay tipped employees less than the minimum wage, as long as employees earn enough in tips to make up the difference. This is called a "tip credit." The credit is the amount the employer doesn't have to pay, so the applicable minimum wage (federal or state) less the tip credit is the least the employer can pay tipped employees per hour.

If an employee doesn't make enough in tips during a given workweek to earn at least the applicable minimum wage for each hour worked, then the employer has to pay the employee the difference. Since Indiana law allows employers to claim a tip credit, [Taxpayer] utilizes the tip credit for its tipped employees. Taxpayer . . . may pay tipped employees an hourly wage as low as \$2.13. Any available wages that are paid by Taxpayer to team members are subject to the withholding tax, collected by Taxpayer and paid to the Indiana Department of Revenue. Because the tipped wage is \$2.13 an hour, in most instances the tipped employee does not have sufficient wages on his or her paycheck for [Taxpayer] to collect all taxes due and owing . . .

Upon review, however, Taxpayer is mistaken. Specifically, the Department in this instance assessed Taxpayer additional withholding taxes under IC § 6-3-4-8 and [45 IAC 3.1-1-97](#), which require Taxpayer to withhold state and county income taxes (collected at the source) on wages paid to employees. Unlike IC § 6-3-4-8 that is in Title 6 for "Taxation," IC § 22-4-4-2 is under Title 22 for "Labor and Safety," which simply establishes the statutory requirement of minimum wages and statutory standards for fair labor practices. In addition, IC § 22-4-4-2 references I.R.C. § 3102, but the taxes under I.R.C. § 3102 are "Employment Taxes" for the "Federal Insurance Contributions Act" ("FICA") purposes and the FICA taxes are not income taxes. Therefore, Taxpayer's reliance on IC § 22-4-4-2 and I.R.C. § 3102 is misplaced.

To correctly examine an employer's income taxes withholding responsibility, we must refer to I.R.C. § 3401 *et seq.*, which is under "Employment Taxes" for the purpose of "Collection of Income Tax at Source on Wages." I.R.C. § 3402(a)(1) which requires an employer to withhold income tax on wages it paid to its employees. I.R.C. § 3401 defines what constitutes "wages" for income tax purposes, which in relevant part, provides:

(a) Wages.--For purposes of this chapter, the term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash; except that such term shall not include remuneration paid--

...

(16)(A) as tips in any medium other than cash;

(B) as cash tips to an employee in any calendar month in the course of his employment by an employer unless the amount of such cash tips is \$20 or more;

...

(f) Tips.--For purposes of subsection (a), the term "**wages**" **includes tips received by an employee in the course of his employment. Such wages shall be deemed to be paid at the time a written statement including such tips is furnished to the employer pursuant to section 6053(a) or (if no statement**

including such tips is so furnished) at the time received.

...
(Emphasis added).

Treas. Reg. § 31.3401(f)-1(a) further explains that, unless specifically excluded such as I.R.C. § 3401(a)(16)(A), (B), or Treas. Reg. § 31.3401(a)(16)-1, "[t]ips received after 1965 by an employee in the course of his employment are considered to be wages, and thus subject to withholding of income tax at source." See Treas. Reg. § 31.3401(a)-1(b)(11); 31.3402(k)-1; See also I.R.C. § 451(c)(stating "tips included in a written statement furnished an employer by an employee pursuant to section 6053(a) shall be deemed to be received at the time the written statement including such tips is furnished to the employer").

I.R.C. § 3402(k) specifically requires the employer to withhold income tax on tips, which provides, in relevant part, as follows:

In the case of tips which constitute wages, subsection (a) shall be applicable only to such tips as are included in a written statement furnished to the employer pursuant to section 6053(a), and only to the extent that the tax can be deducted and withheld by the employer, at or after the time such statement is so furnished and before the close of the calendar year in which such statement is furnished, from such wages of the employee (excluding tips, but including funds turned over by the employee to the employer for the purpose of such deduction and withholding) as are under the control of the employer; and an employer who is furnished by an employee a written statement of tips (received in a calendar month) pursuant to section 6053(a) to which paragraph (16)(B) of section 3401(a) is applicable may deduct and withhold the tax with respect to such tips from any wages of the employee (excluding tips) under his control, even though at the time such statement is furnished the total amount of the tips included in statements furnished to the employer as having been received by the employee in such calendar month in the course of his employment by such employer is less than \$20. Such tax shall not at any time be deducted and withheld in an amount which exceeds the aggregate of such wages and funds (including funds turned over under section 3102(c)(2) or section 3202(c)(2)) minus any tax required by section 3102(a) or section 3202(a) to be collected from such wages and funds.

Treas. Reg. § 31.3402(k)-1(a)(1) details the general rules which apply to tips, as follows:

Subject to the limitations set forth in paragraph (a)(2) of this section, an employer is required to deduct and withhold from each of his employees tax in respect of those tips received by the employee which constitute wages. (For provisions relating to the treatment of tips as wages, see §§ 3401(a)(16) and 3401(f).) The employer shall make the withholding by deducting or causing to be deducted the amount of the tax from wages (exclusive of tips) which are under the control of the employer or other funds turned over by the employee to the employer (see paragraph (a)(3) of this section). For purposes of this section the terms "wages (exclusive of tips) which are under the control of the employer" means, with respect to a payment of wages, an amount equal to wages as defined in section 3401(a) except that tips and noncash remuneration which are wages are not included, less the sum of—

- (i) The tax under section 3101 required to be collected by the employer in respect of wages as defined in section 3121(a) (exclusive of tips);
- (ii) The tax under section 3402 required to be collected by the employer in respect of wages as defined in section 3401(a) (exclusive of tips); and
- (iii) The amount of taxes imposed on the remuneration of an employee withheld by the employer pursuant to State and local law (including amounts withheld under an agreement between the employer and the employee pursuant to such law) except that the amount of taxes taken into account in this subdivision shall not include any amount attributable to tips.

Treas. Reg. § 31.3402(k)-1(a)(2) explains further:

An employer is required to deduct and withhold the tax on tips which constitute wages only in respect of those tips which are reported by the employee to the employer in a written statement furnished to the employer pursuant to section 6053(a). The employer is responsible for the collection of the tax on tips reported to him only to the extent that the employer can, during the period beginning at the time the written statement is submitted to him and ending at the close of the calendar year in which the statement was submitted, collect the tax by deducting it or causing it to be deducted as provided in [Treas. Reg. § 31.3402(k)-1(a)(1)].

Treas. Reg. § 31.3402(k)-1(a)(3) provides that employees may furnish funds to employers to be withheld, as

follows:

If the amount of the tax in respect of tips reported by the employee to the employer in a written statement furnished pursuant to section 6053(a) exceeds the wages (exclusive of tips) which are under the control of the employer from which the employer is required to withhold the tax in respect of such tips, the employee may furnish to the employer, within the period specified in subparagraph (2) of this paragraph, an amount of money equal to the amount of such excess.

Recognizing that an employer may not be able to fully deduct and withhold all taxes on tip income from the wages under the employer's control or from the funds turned over by the tipped employees, Treas. Reg. § 31.3402(k)-1(c)(1) further establishes a priority of the taxes to be withheld, which provides:

In the case of a payment of wages (exclusive of tips), the employer shall deduct or cause to be deducted in the following order:

(i) The tax under section 3101 and the tax under section 3402 with respect to such payment of wages.

(ii) Any tax under section 3101 which, at the time of payment of the wages, the employer is required to collect—

(a) In respect of tips reported by the employee to the employer in a written statement furnished to the employer pursuant to section 6053(a), or

(b) By reason of the employer's election to make collection of the tax under section 3101 in respect of tips on an estimated basis,

but which has not been collected by the employer and which cannot be deducted from funds turned over by the employee to the employer for such purpose. (See § 31.3102-3, relating to collection of, and liability for, employee tax on tips.)

(iii) **Any tax under section 3402 which, at the time of the payment of the wages, the employer is required to collect—**

(a) In respect of tips reported by the employee to the employer in a written statement furnished to the employer pursuant to section 6053(a), or

(b) By reason of the employer's election to make collection of the tax under section 3402 in respect of tips on an estimated basis,

but which has not been collected by the employer and which cannot be deducted from funds turned over by the employee to the employer for such purpose. For provisions relating to the withholding of tax on the basis of average estimated tips, see paragraph (b) of § 31.3402(h)(1)-1. **(Emphasis added).**

Treas. Reg. § 31.3402(k)-1(c)(2) further offers some examples to illustrate the application of the priority. In short, an employer is required to first withhold the taxes on the non-tip wages it paid to the tipped employees. Thereafter, if there is remaining amount available, the employer is required to withhold the taxes on tips in the following order: (1) FICA taxes under I.R.C. § 3101, (2) federal income tax under I.R.C. § 3402, and (3) state and local taxes. In other words, after the statutorily required withholding taxes from the non-tip wages has been satisfied, the employer must then deduct and withhold federal taxes imposed on tip income from the remaining non-tip wages, which are under its control. Under the federal procedures, if the amount of remaining wages is not sufficient to cover the federal amount required to be withheld on tip income, the amount of tax which remains unsatisfied should be withheld from the wages under the control of the employer the following pay period. I.R.S. Publication 15, at 17-18; *see also* Form 8027 and instructions.

In this instance, Taxpayer argued that it did "not owe the taxes being assessed when an employee had a zero net check." The Department is not able to agree. Pursuant to the above-mentioned statutes and regulations, Taxpayer was required to withhold the income tax on tipped employees' tips. Taxpayer may defer its obligation of state and local income tax withholding on tips to the following pay period (or periods) provided that certain requirements were satisfied. Taxpayer stated that it claimed "tip credit" and paid its tipped employees at \$2.13 per hour in general as non-tip wages. Taxpayer was first required to withhold the state and county income taxes on

the non-tip wages it paid to its tipped employees because the non-tip wages were regular wages subject to state and county tax withholding. After it properly withheld all taxes applicable to the non-tip wages and there was remaining non-tip wages (under its control), Taxpayer was required to deduct and withhold taxes on tips from the remaining non-tip wages under its control or from the fund turned over by its employees according to the well-established tax withholding priority under Treas. Reg. § 31.3402(k)-1(c)(1). While its employees were required to report to Taxpayer the amount of the tips they received, Taxpayer was required to document and report the amount of the withholding taxes as well as to track the withholding taxes which were deferred when it withheld in the following pay period. Only when Taxpayer properly documented (1) that it withheld taxes on the non-tip wages, (2) that it withheld taxes on tips from the remaining non-tip wages (under its control) or from the fund turned over by its employees, and (3) that it could not withhold taxes on the tips from the non-tip wages or the fund turned over by its employees in the following pay period (or periods) before the close of the calendar year, was Taxpayer relieved from its statutory obligation to withhold the state and local taxes on tips for that tax year. I.R.C. § 3402(k). See I.R.C. § 6053, Treas. Reg. § 31.6053-1 *et. seq.*, I.R.S. Publication 1244, Form 4070 and instructions. A further review of Taxpayer's supporting documentation showed that Taxpayer also failed to do that.

In short, Taxpayer was required to withhold Indiana and county income taxes on tips received by the tipped employees who resided and/or worked in Indiana because tips were wages subject to income tax withholding. Taxpayer's supporting documentation failed to establish that it properly withheld the taxes on wages, tips or otherwise, paid to its tipped employees. Given the totality of the circumstances, in the absence of other supporting documentation, the Department is not able to agree that Taxpayer met its burden demonstrating that the proposed assessment is incorrect.

Nonetheless, Taxpayer may provide the required supporting documentation, as discussed above, within 30 days from the date of the issuance of this Letter of Findings, to request a rehearing.

FINDING

Taxpayer's protest is respectfully denied.

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