

**Letter of Findings: 03-20170391**  
**Withholding Tax**  
**For the Years 2014 and 2015**

**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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 did not establish that it was in compliance with the withholding tax ordering requirements.

**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; *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; [45 IAC 3.1-1-97](#); I.R.S. Publication 15; I.R.S. Publication 1244; I.R.S. Tax Topic 761 Tips - Withholding and Reporting.

Taxpayer protests the audit's adjustment of Indiana and county withholding tax.

**STATEMENT OF FACTS**

Taxpayer, an S-Corporation, is a restaurant located in Indiana. For the tax years 2014 and 2015 the Indiana Department of Revenue ("Department") conducted a withholding tax audit of Taxpayer's business records. As a result of the audit, the Department issued proposed assessments for base tax and interest for the years at issue. Taxpayer in turn filed a protest with the Department. A telephone hearing was conducted regarding the protest. This Letter of Findings ensues and additional facts will be provided as necessary.

**I. Withholding Tax - Imposition.**

**DISCUSSION**

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).

The audit report states that a "review of the taxpayer's withholding records was conducted for calendar years 2014 and 2015. The records reviewed were the taxpayer's W-2's, WH-1's, and WH-3's. After reviewing the taxpayer's W-2's, it was found that state tax or county tax was not being withheld from a few of the employees."

Taxpayer states that "[d]uring a recent audit it was determined that several of the tipped employees did not have local taxes deducted from the paychecks. These tipped employees had 'negative pay checks' which means their tips where [sic] large enough so that it created a shortfall on there [sic] taxes." Taxpayer further states that "[s]everal of these tipped employees provided me with canceled checks where they paid these 'shortfall taxes' when filling [sic] there [sic] personal income taxes." Taxpayer, post-hearing, sent a letter with enclosures. Taxpayer states that the enclosures shows that "several of the employees listed in the recent audit that have either paid in full there [sic] 2014 & 2015 State and Local taxes that occurred due to shortfall . . . ."

Turning to an analysis of the relevant law, 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.

The Department 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. 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.

I.R.S. Tax Topic 761, which tracks the analysis above, states in relevant part:

You collect the employee's portion of these taxes from the wages you pay your employee, or from funds the employee gives you. If you don't have enough money from the employee's wages and funds your employee gives you, withhold taxes in the following order:

1. Social security and Medicare taxes on the employee's wages,
2. Federal income taxes on the employee's wages,
3. State and local taxes imposed on the employee's wages,
4. Social security and Medicare taxes on the employee's reported tips, and
5. Federal income taxes on the employee's reported tips.

I.R.S. Tax Topic 761 Tips - Withholding and Reporting, <https://www.irs.gov/taxtopics/tc761?vm=r> (last visited November 20, 2017).

Taxpayer, pursuant to [45 IAC 3.1-1-97](#) is "required to withhold from employee's wages Adjusted Gross and County Adjusted Income Tax." In the context of employees that receive income from tips, it is incumbent upon Taxpayer to comply with the withholding tax ordering requirements outlined above. Taxpayer has failed to establish that it complied with those requirements. Taxpayer instead provided various tax documents of some of its employees. Those documents do not establish that the withholding taxes at issue were actually paid—nor does Taxpayer's argument relieve it of the withholding duty imposed upon it by [45 IAC 3.1-1-97](#). Taxpayer has not met its burden of proof under IC § 6-8.1-5-1(c).

### FINDING

Taxpayer's protest is denied.

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An [html](#) version of this document.