



# PAYROLL CURRENTLY

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## Status Report on Minimum Wage Legislation Pending in Congress

Since PAYROLL CURRENTLY last reported on this legislation, the path to an increase in the federal minimum wage has taken an unanticipated turn, and the timing of any increase remains in doubt.

The U.S. House of Representatives (1-7-07) and Senate (2-1-07) have both approved the "Fair Minimum Wage Act of 2007" by large margins. However, the House and Senate have not yet reached an agreement on a package of business tax incentives to accompany the increase (see PAYROLL CURRENTLY, Issue Nos. 4 and 5, Vol. 15).

To break the impasse and spur House-Senate negotiations on a final version of the minimum wage bill, the minimum wage and business incentives legislation was tacked on to H.R. 1591,

an unrelated "war supplemental" appropriations bill, and re-approved. The House approved its version of H.R. 1591 on March 23 (218-212), and the Senate approved its version of H.R. 1591 on March 29 (51-47).

Before adjourning following passage of its version of H.R. 1591, the Senate appointed conferees to a committee to negotiate a final version of the bill. House conferees will likely be appointed when members return after a holiday recess scheduled to last until April 16. The main stumbling block now seems to be President Bush's opposition to the tax offsets in the Senate version and his reluctance to approve a supplemental appropriations bill containing a date for bringing U.S. troops home from Iraq.

*Note:* The Fair Minimum Wage Act of 2007 would increase the federal hourly minimum wage rate to:

- \$5.85, effective 60 days after the date of enactment;
- \$6.55, effective 12 months after the date of enactment; and
- \$7.25, effective 24 months after the date of enactment.

The bill would also specify an hourly minimum wage rate for the Northern Mariana Islands (NMI) of \$3.55, effective 60 days after the date of enactment. This rate would be increased by \$0.50 an hour (or, if necessary, a lesser amount) every six months thereafter until the minimum wage applicable to the NMI is equal to the federal hourly minimum wage in the U.S. **PC**

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## Employer Could Not Use Employment Eligibility Verification Process to Intimidate Employees

From the day it first opened for business in 1989, Glenview Car Wash, Inc., of Glenview, Illinois, never required any of its employees to complete a Form I-9, *Employment Eligibility Verification*. In 2005, several Glenview employees filed a class action lawsuit against the car wash under Title VII of the Civil Rights Act of 1964 (sexual harassment and hostile work environment). A few months later, in April 2006, Glenview contacted all of its employees and requested that they complete, for the first time ever, employment applications and Forms I-9, saying that this was necessary in order to comply with immigration laws.

The court questioned the timing of Glenview's action, saying it just was "not plausible that this employer, in business since 1989, would now discover for the first time that its employee files were deficient," and concluded that the company's main purpose was to

intimidate employees (potential class members) trying to safeguard their rights under Title VII. Allowing Glenview to require immigration verification during the lawsuit, said the court, would actually undermine compliance with immigration laws because the primary motivation to employers for hiring undocumented workers is that such workers are unlikely to complain if they are mistreated because they fear deportation. Safeguarding the rights of undocumented workers to seek enforcement of laws like Title VII removes a primary motivation for employers to hire such workers in the first place.

Accordingly, the court barred Glenview from seeking any information from its employees about their immigration status until the conclusion of the lawsuit [*Equal Employment Opportunity Commission v. Glenview Car Wash, Inc.*, No. 05C 5568, 2006 U.S. Dist. LEXIS 88979 (ND Ill., 5-5-06)]. **PC**

## Capitol Hill Update

The following are some of the payroll-related bills that have been introduced in the House and Senate since the 110th Congress convened in January.

### Child support

H.R. 1386/S. 803 – known as the Child Support Protection Act – would restore federal assistance to state child support programs that was cut by the Deficit Reduction Act of 2005 (Pub. L. No. 109-171; see [PAYROLL CURRENTLY Issue No. 6, Vol. 14](#)). The APA strongly supports this legislation (see [“Inside Washington” for March 2007](#)).

### Commuters

H.R. 1360/S. 785 – known as the Telecommuters Tax Fairness Act – would prohibit a state from imposing an income tax on the compensation of nonresidents for any period when they

are not physically present or working in the state (see [PAYSTATE UPDATE](#), Issue No. 7, Vol. 9 for a detailed discussion of this legislation).

H.R. 1475/S. 712 – known as the Commuter Benefits Equity Act – would equalize the exclusion from gross income for qualified parking and transportation fringe benefits and provide for a common cost-of-living adjustment.

### W-2 reporting

H.R. 666/H.R. 847 – known as the Healthcare Disclosure Act – would require that amounts paid for employer-provided coverage under accident or health plans be included on Forms W-2.

### Immigration and employment authorization

H.R. 19 – would rename the Basic Pilot Program (see *The Payroll*

*Source*®, pp. 1-25 to 1-27) as the Employment Eligibility Verification System, provide for its permanent nationwide implementation, and phase in mandatory employer participation.

H.R. 98 – known as the Illegal Immigration Enforcement and Social Security Protection Act – would require encrypted machine-readable electronic identification strips on social security cards, prohibit individuals from commencing employment with a U.S. employer absent a social security card that meets these requirements (and presentation of the card to the employer), and establish an Employment Eligibility Database with information from the Social Security Administration and Department of Homeland Security on citizenship status and work eligibility. **PC**

## Changes Made to Federal Per Diem Rates

Several changes have been made to the list of federal per diem rates for travel to locations within the continental U.S. (CONUS). FTR Per Diem Bulletin 07-3 is effective for travel undertaken on or after March 30, 2007 [72 F.R. 14110, 3-26-07]. The Bulletin is available on the APA Web site at [www.payroll.org/i4a/pages/index.cfm?pageid=139](http://www.payroll.org/i4a/pages/index.cfm?pageid=139). The changes are as follows:

### California

- The entry for *Monterey* is modified to add a new seasonal lodging rate. The lodging rate is increased to \$123 (was \$111) from March 30 – September 30.

- The entry for *Oakland* is modified to add a new seasonal lodging

rate. The lodging rate is increased to \$98 (was \$94) from March 30 – September 30.

- The entry for *San Mateo/Foster City/Belmont* is modified to add a new seasonal lodging rate. The lodging rate is increased to \$107 (was \$98) from March 30 – September 30.

- The entry for *Santa Barbara* is modified to add new seasonal lodging rates. The lodging rate is increased to \$137 (was \$130) from March 30 – June 30; to \$181 (was \$169) from July 1 – August 31; and to \$137 (was \$130) from September 1 – September 30.

### Georgia

- An entry for *Peachtree City/Jonesboro/Morrow/Newnan* is added and seasonal rates are created. From

March 30 – September 30, the lodging rate is set at \$76 (was \$60) and the M&IE rate is set at \$44 (was \$39), so that the maximum per diem rate is \$120 (was \$99).

- The entry for *Savannah* is modified to add new seasonal lodging rates. The lodging rate is increased to \$113 (was \$95) from March 30 – April 30 and to \$102 from May 1 – September 30.

### Idaho

- An entry for *Mountain Home* is added and seasonal rates are created. From March 30 – September 30, the lodging rate is set at \$65 (was \$60) and the M&IE rate is set at \$44 (was \$39), so that the maximum per diem rate is \$109 (was \$99).

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## Payroll Solutions

**Q.** The ownership of our company has changed and several of our top executives will soon be leaving. When this happens, they will each receive a “golden parachute” payment to soften their landing. How should these payments be reported and taxed?

**A.** The IRS has special rules governing these payments (see *The Payroll Source*®, p. 3-76). Under IRS rules, a “parachute payment” is compensation paid to an officer, shareholder, or highly compensated employee only after a change in corporate ownership or control that is at least three times the employee’s average compensation during the five most recent tax years. An “excess parachute payment” is the portion of the parachute payment that exceeds the employee’s five-year average compensation.

The entire parachute payment is wages and is subject to federal income tax withholding and social security (up to the wage base) and Medicare taxes. The excess parachute payment is also subject to a 20% excise tax the employer must withhold. (Note: FUTA tax rules have not been amended to reflect changes relating to parachute payments.) The employer must report the payment on Form W-2, with the withheld excise tax entered in Box 12, preceded by Code “K.”

EXAMPLE: An employee receives a parachute payment of \$1,000,000 after his company is bought and he is asked to resign as president. The employee’s average compensation for the last five years was \$300,000. The entire \$1,000,000 parachute payment is subject to federal income tax withholding and social security (up to the applicable wage limit) and Medicare taxes, while 20% of the excess payment of \$700,000 (\$140,000 = \$700,000 x 20%) must also be withheld to pay excise taxes.

### Kentucky

- The entry for *Kenton County* is modified to add a new seasonal lodging rate. The lodging rate is increased to \$103 (was \$94) from March 30 – September 30.

### Louisiana

- An entry for *Lafayette* is added and seasonal rates are created. From March 30 – September 30, the lodging rate is set at \$78 (was \$60) and the M&IE rate is set at \$49 (was \$39), so that the maximum per diem rate is \$127 (was \$99).

### Maryland

- The entry for *Frederick* is modified to add a new seasonal lodging rate. The lodging rate is increased to \$87 (was \$85) from March 30 – September 30.

### Mississippi

- An entry for *Grenada* is added and seasonal rates are created. From March 30 – September 30, the lodging rate is set at \$67 (was \$60) and the M&IE rate is set at \$44 (was \$39), so that the maximum per diem rate is \$111 (was \$99).

- An entry for *Hattiesburg* is added and seasonal rates are created. From March 30 – September 30, the lodging rate is set at \$74 (was \$60) and the M&IE rate is set at \$49 (was \$39), so that the maximum per diem rate is \$123 (was \$99).

- An entry for *Southaven* is added and seasonal rates are created. From

March 30 – September 30, the lodging rate is set at \$84 (was \$60) and the M&IE rate is set at \$44 (was \$39), so that the maximum per diem rate is \$128 (was \$99).

### Missouri

- An entry for *Columbia* is added and seasonal rates are created. From March 30 – September 30, the lodging rate is set at \$72 (was \$60), so that the maximum per diem rate is \$111 (was \$99).

### Montana

- The entry for *Butte* is modified to add a new seasonal lodging rate. The lodging rate is increased to \$71 (was \$65) from March 30 – September 30.

### Ohio

- The entry for *Cincinnati* is modified to add a new seasonal lodging rate. The lodging rate is increased to \$103 (was \$86) from March 30 – September 30.

### South Carolina

- The entry for *Charleston* is modified to add a new seasonal lodging rate. The lodging rate is increased to \$98 (was \$86) from March 30 – September 30.

### Utah

- An entry for *Layton* is added and seasonal rates are created. From March 30 – September 30, the lodging rate is set at \$64 (was \$60) and the M&IE rate is set at \$44 (was \$39), so that the maximum per diem rate is \$108 (was \$99).

### Wyoming

- An entry for *Casper* is added and seasonal rates are created. From March 30 – September 30, the lodging rate is set at \$64 (was \$60) and the M&IE rate is set at \$44 (was \$39), so that the maximum per diem rate is \$108 (was \$99).

- An entry for *Rock Springs* is added and seasonal rates are created. From March 30 – September 30, the lodging rate is set at \$71 (was \$60) and the M&IE rate is set at \$44 (was \$39), so that the maximum per diem rate is \$115 (was \$99).

- An entry for *Gillette* is added and seasonal rates are created. From March 30 – September 30, the lodging rate is set at \$74 (was \$60) and the M&IE rate is set at \$49 (was \$39), so that the maximum per diem rate is \$123 (was \$99).

- An entry for *Sheridan* is added and seasonal rates are created. From March 30 – June 30, the lodging rate is set at \$63 (was \$60) and the M&IE rate is set at \$49 (was \$39), so that the maximum per diem rate is \$112 (was \$99). From July 1 – August 31, the lodging rate is set at \$83 (was \$60) and the M&IE rate is set at \$49 (was \$39), so that the maximum per diem rate is \$132 (was \$99). From September 1 – September 30, the lodging rate is set at \$63 (was \$60) and the M&IE rate is set at \$49 (was \$39), so that the maximum per diem rate is \$112 (was \$99). **PC**

## IRS Issues Final Regulations on Limits on Benefits and Contributions Under Qualified Plans

The IRS has issued comprehensive final regulations under IRC §415 on the limitations on benefits and contributions under qualified plans [72 F.R. 16878, 4-5-07; <http://a257.g.akamaitech.net/7125712422/01jan20071800/edocket>.

[access.gpo.gov/2007/pdf/E7-5750.pdf](http://access.gpo.gov/2007/pdf/E7-5750.pdf)]. The regulations will affect administrators of, participants in, and beneficiaries of qualified employer plans and other retirement plans.

Only minor changes to the regulations have been made since comprehensive regulations under §415 were last issued in 1981. Since that time, however, many significant changes affecting §415 have been made by statutes, IRS notices, revenue rulings, and other guidance. The final regulations reflect this guidance with some modifications, as well as other statutory changes not previously addressed, and make other changes and clarifications to existing regulations. The regulations also make conforming changes to regulations under §401(a)(9), §401(k), §403(b), and §457.

The most important substantive changes from the existing final regulations or existing guidance of interest to payroll professionals are noted below. These changes were previewed in proposed regulations issued May 31, 2005 (70 F.R. 31214; see **PAYROLL CURRENTLY, Issue No. 13, Vol. 13**).

### Severance from employment

The final regulations provide that amounts received following severance from employment are generally not considered compensation for §415 purposes, but provide an exception for certain payments made by the later of (1) 2½ months following severance from employment or (2) the end of the limitation year that includes the date of severance from employment (this modifies the period specified in the proposed regulations). The final regulations also include a provision permitting a governmental plan to substitute the calendar year that includes the date of severance for the limitation year that includes the date of severance from employment.

Payments covered by the exception include payments (such as regular compensation, and payments for overtime, shift differentials, commissions, and bonuses) that would have been payable if employment had not

terminated.

Under the final regulations, payments with respect to accrued bona fide sick, vacation, or other leave that would have been available for use by the employee if employment had not terminated are not included in compensation unless the plan specifically includes such payments.

Additionally, the final regulations permit a plan to specify that a post-severance payment from a nonqualified unfunded deferred compensation plan may be included in compensation if the payment is made within the timeframe described above, but only if the payment would have been made at the same time if the employee had continued his or her employment and only to the extent that the payment is includible in the employee's gross income.

As under the proposed regulations, therefore, compensation does not include amounts paid after severance from employment, even if they are paid within the allowable period following severance, that are severance pay or parachute payments.

The rule pursuant to which compensation received after severance from employment is not considered compensation for §415 purposes generally does not apply to payments to an individual in qualified military service up to the amount the individual would have received if he or she was still working for the employer. In other words, employees may continue to contribute to their employers' retirement plans while performing qualified military service. Note that this seems to be at odds with the IRS position that supplemental pay from an employer to an employee in active service with the U.S. Armed Forces or on an indefinite assignment with the state National Guard is not wages (see **PAYROLL CURRENTLY, Issue No. 18, Vol. 12**).

The final regulations add another exception to the post-severance timing rule for compensation paid to a permanently and totally disabled participant, provided certain conditions are met.

Corresponding changes are

### News Notes...

#### Back Pay Awarded to Demoted Employee Was Income

Diane Campbell appealed to the federal Merit Systems Protection Board (MSPB) when the reclassification of her job in the Treasury Department's Office of Thrift Supervision (OTS) resulted in her demotion from a supervisory to a nonsupervisory position. On appeal, the MSPB ordered her reinstated to her old position and awarded her back pay and interest.

In 2002, Campbell received a final payment of \$1,446 under the MSPB order. The payment was reported on Form 1099-MISC, but Campbell did not include it on her 2002 federal income tax return. After the IRS assessed a deficiency, she appealed to the U.S. Tax Court, arguing that the award was compensation for a personal injury and therefore excludable from income under IRC §104(a)(2).

To be excludable from gross income under §104(a)(2), a payment must be made "on account of personal physical injuries or physical sickness." (Note: In 1994, when the MSPB issued its final order awarding Campbell back pay and interest, §104(a)(2) did not require that an injury or sickness be physical.)

The court said the IRS correctly assessed a deficiency against Campbell. The award was not excludable from her gross income. She never claimed that she suffered any personal injury or sickness because of OTS's actions. The award was not compensation to her for missing work due to any personal injuries or sickness, but was designed to replace the pay and benefits she lost due to her improper demotion [*Campbell v. Commissioner*, T.C. Summary Op. 2007-51, No. 7830-05S (3-28-07)].

proposed for the regulations under §401(k), §403(b), or §457(b), so that amounts receivable following severance from employment can only be deferred if those amounts meet these conditions.

#### **Determining the participant's high three years' average compensation**

The proposed regulations made two changes affecting the determination of a participant's average compensation for his or her high three consecutive years. Only one of these changes has been adopted in the final regulations.

A proposed provision that compensation used for this purpose would be restricted to compensation earned while the participant was an active participant in the plan has not been adopted.

On the other hand, a provision clarifying the interaction of the requirements of §401(a)(17) and the definition of compensation that must be used for determining a participant's average compensation for the participant's high three consecutive years has been adopted. Under the final regulations, because a plan is not permitted to base benefits on compensation in excess of the limitation under §401(a)(17), a plan's definition of compensation for purposes of applying the §415 limitations may not reflect compensation in excess of the

limitation under §401(a)(17).

**EXAMPLE:** A participant begins receiving benefits in 2008. The participant had compensation in excess of the applicable §401(a)(17) limit for 2005, 2006, and 2007. The participant's benefit determination under the plan is limited by the average compensation for his highest three years as limited by §401(a)(17).

#### **More than one annuity starting date**

The final regulations reserve a place for new rules on determining the annual benefit under a defined benefit plan where there has been more than one annuity starting date (e.g., where application of the §415 limits must take into account prior distributions as well as currently commencing distributions). The proposed regulations are withdrawn; new proposed regulations are being developed.

In the interim, the final regulations provide that if a participant has or will have distributions beginning at more than one starting date, then the limitations of §415 must be satisfied as of each of the annuity starting dates, taking into account the benefits that have been or will be provided at all of these dates. In determining the annual benefit of a participant as of a particular annuity starting date, the plan is required

to actuarially adjust past and future distributions with respect to the benefit that commenced at the other annuity starting dates.

#### **Effective date**

The regulations generally apply to limitation years beginning on or after July 1, 2007. Note that the benefits that are grandfathered from the application of the regulations has been expanded.

A defined benefit plan adopted and effective before April 5, 2007, will be considered to satisfy §415 limitations with respect to benefits accrued or payable as of the end of the limitation year immediately prior to the effective date of the final regulations if the plan's provisions meet the requirements of statutory provisions, regulations, and other guidance in effect immediately before that effective date. However, such a plan will not be permitted to provide for the accrual of additional benefits on or after the effective date of these new final regulations unless both the additional benefits and the participant's other accrued benefits comply with the final regulations.

Taxpayers may apply post-severance compensation payments and other compensation timing rules in the final regulations for years prior to the effective date of the final regulations. **PC**

## **Time Out of Work After Wrongful Termination Counted Toward FMLA Eligibility**

The time an employee would have worked but for his/her unlawful termination must be counted when determining the employee's eligibility for leave under the Family and Medical Leave Act (FMLA) [*Savage v. Chicago Transit Authority*, No. 06 C 1407, 2007 U.S. Dist. LEXIS 17605 (ND Ill., 3-9-07)].

#### **Background**

On October 11, 2003, the Chicago Transit Authority (CTA) indefinitely suspended bus driver Robert Steele and eventually terminated his employment. Steele contested the termination and on November 18, 2005, an arbitrator ordered that he be reinstated to his former position with back pay, less his interim earnings.

In April 2006, the CTA denied Steele's request for FMLA leave, saying that he

had not worked the required minimum number of hours during the preceding 12 months. Steele sued the CTA when he was disciplined for taking four days of FMLA leave to care for his wife.

#### **Determining an employee's hours of service**

**Periods when no work is performed.** To be eligible for leave under the FMLA, an employee must have been employed for at least 12 months by the employer and must have been employed for at least 1,250 "hours of service" during the previous 12-month period (29 USC §2611(2)).

Department of Labor regulations provide that in determining an employee's hours of service under the FMLA, the standards of the Fair Labor Standards Act (29 USC §207) apply. Under

§207, an employee's regular rate of pay for overtime calculation purposes does not include compensation for periods when no work is performed due to vacation, holidays, illness, an employer's failure to provide work, "or other similar cause."

The court explained that unlawful termination by an employer is not an "other similar cause" under §207. Time not worked because of unlawful termination must therefore be included in the regular rate of pay when calculating overtime. Similarly, time that an employee is unlawfully prevented from working must be included when calculating whether he or she has satisfied the FMLA's hours-of-service requirement.

**Hours the employee would have worked.** Back pay awards often include

payment for overtime work that the employee would have performed but for the employer's violation of employment laws, based on the employee's employment history. Therefore, an employee's "hours of service" under the FMLA should include the hours that employee is deemed to have worked under a "make whole" award – i.e., those hours that are ordered to be repaid.

Had Steele not been discharged,

said the court, he would have worked the required number of hours. At 40 hours per week over the 41-week period between the date of his discharge and the date his reinstatement was ordered, Steele would have worked 1,640 hours. Even taking into account vacations, absences, and holidays, he would still have worked the required 1,250 hours. He was therefore an FMLA-eligible employee at the time he requested leave

in April 2006.

*Note:* A 2004 decision of the Sixth Circuit Court of Appeals reached the same conclusion (*Ricco v. Potter*, see [PAYROLL CURRENTLY, Issue No. 3, Vol. 13](#)). However, a 2002 decision of the First Circuit Court of Appeals (*Plumley v. Southern Container, Inc.*, 303 F.3d 364 (1st CA, 9-13-02)) reached the opposite conclusion. **PC**

## Employer Did Not Have Reasonable Cause for Not Paying Employment Taxes Timely

The Fifth Circuit Court of Appeals has affirmed that Staff IT, Inc., an information technology staffing company in Houston, Texas, was not entitled to abatement of penalties imposed by the IRS for failure to timely file, pay, and deposit employment taxes. The company was not entitled to abatement because it did not have "reasonable cause" for its action [*Staff IT, Inc. v. U.S.*, No. 06-20292, 2007 U.S. App. LEXIS 6753 (5th CA, 3-22-07)].

**WHAT THE LAW SAYS** - Under IRC §6651(a)(1) (file), IRC §6651(a)(2) (pay), and IRC §6656(a) (deposit), additions to tax may be excused if the failure to perform the required action was the result of "reasonable cause" and not willful neglect. To demonstrate reasonable cause, a taxpayer must show that it exercised "ordinary business care and prudence" but was nonetheless unable to file the return (or pay or deposit the taxes) within the prescribed time.

One federal appellate court case – *Brewery Inc. v. U.S.*, 33 F.3d 589 (6th CA, 1994) – said that a taxpayer's financial difficulties can *never* constitute reasonable cause. However, other federal appellate courts use a "multifactor"

approach to assess the facts and circumstances to determine whether the taxpayer exercised ordinary business care and prudence in attending to its payroll tax obligation. Courts applying the multifactor approach look to a taxpayer's expenditures before and after the taxpayer failed to pay withholding taxes, as well as the taxpayer's treatment of other creditors in comparison with the IRS.

### Analysis

The court found that Staff IT did not exercise ordinary business care and prudence in balancing its IRS obligations against competing financial commitments under both the *Brewery* and multifactor approaches.

**Failure to file.** Staff IT was not entitled to abatement for failure to file. Although the company encountered financial difficulties in late 2001 and early 2002 (the bankruptcy of the company financing its accounts receivable; the loss of large clients such as Enron, Dynegy, Global Crossing, and Compaq; and the financial impact of the September 11 terrorist attacks), and that might have affected its ability to *pay and deposit* employment taxes, it had no bearing on

the company's ability to *file*.

**Failure to pay and deposit.** In determining whether a taxpayer has exercised ordinary business care, the primary factors are whether (1) the taxpayer has favored other nonessential creditors over the IRS (weighs heavily against a finding of reasonable cause), and whether (2) the taxpayer was willing to cut costs and personnel (weighs in favor of a finding of reasonable cause).

Here, despite its heavy losses in the fourth quarter of 2001 and the first quarter of 2002, the company paid virtually all of its creditors, employee and officer wages and salaries, and operating expenses, instead of meeting its payroll tax obligations. Moreover, nothing was done to reduce costs and personnel until March and April 2002, when the company laid off some employees and contractors and reduced officers' compensation. The court said that abatement of penalties for failure to pay and deposit was not warranted. "To conclude otherwise would be to sanction [Staff IT's] unilateral self-execution of a government loan" (see [PAYROLL CURRENTLY, Issue No. 5, Vol. 14](#), for prior coverage of this case). **PC**

## Restaurant Management's Retention of Banquet Tips Violated the FLSA

A restaurant that used a portion of its tipped employees' tip pool to pay the hourly wages of part-time employees and retained a portion of an add-on charge for banquets, was not entitled to take a tip credit under the Fair Labor Standards Act (FLSA), a U.S. District Court has ruled [*Chan v. Sung Yue Tung Corp.*, No. 03 Civ 6048 (GEL), 2007 U.S. Dist. LEXIS 7770 (SD N.Y., 2-1-07)].

### Background

The 88 Palace Restaurant in New York City's Chinatown paid tipped employees wages below minimum requirements and took a tip credit for the difference. The restaurant also operated a tip pooling system under which customer tips were combined and distributed among waiters, busboys, captains, and the management, which also used money from the tip pool to pay banquet employees.

Customers who hosted large parties or banquets were required to pay an additional 15% on top of the cost of the banquet. The restaurant used the 15% payment first to pay half of the wages of part-time employees working at the banquet, then put 75% of the remainder into the tip pool and kept 25%.

Eleven waiters, busboys, and captains sued 88 Palace for violating the tip credit provisions of the FLSA.

☞ **WHAT THE LAW SAYS** – Under the FLSA (29 USC §203(m)), an employer is only required to pay a “tipped employee” \$2.13 an hour, so long as the employee’s tips are enough to bring his/her wage up to the minimum wage then in effect (see *The Payroll Source*®, p. 2-35). In other words, this “tip credit” can relieve an employer from paying as much as \$3.02 per hour to a tipped employee. In order to take advantage of the FLSA’s tip credit, (1) the employer must inform the tipped employee about it and (2) all tips received by the employee must be retained by him/her, except that pooling of tips is permitted among employees who “customarily and regularly receive tips.”

#### Notice

The restaurant failed to provide proper notice to tipped employees. In fact, initially, 88 Palace failed to post *any* notice of the minimum wage laws or tip rules. The

restaurant eventually posted a notice, but it was posted in an inconspicuous place and in English only, a language that few of the Chinese immigrant employees could read.

#### Banquet add-on

The court said the 15% banquet add-on was a tip (a sum presented by a customer as a gift or gratuity, not compensation by the employer), as opposed to a service charge (a mandatory charge imposed by an employer on a customer that is the employer’s property and becomes part of the employer’s gross receipts). The Chinese words on the restaurant’s menu labeled the charge as a tip. Customers understood that the charge would be given to employees as tips and almost never left any additional tip for those who had served them; they were never told that the management of 88 Palace retained a portion of the charge for itself.

By retaining a portion of the banquet add-on, the restaurant violated the second requirement for using the tip credit. Moreover, it improperly used part of the employees’ tip pool to pay part-time banquet workers, who were paid an hourly wage and not tips.

#### Conclusion

The court said the restaurant was disqualified from using the tip credit and had to pay the employees the full minimum hourly wage. Moreover, the employees were entitled to recover the portion of their tips illegally retained by the restaurant for its own use or for payment of part-time workers’ hourly wages. Finally, the employees were entitled to the difference between the reduced hourly overtime rate they were paid because of the restaurant’s improper use of the tip credit and the overtime rate of 1½ times the minimum wage. **PC**

## Canine Officers’ Off-Duty Time Spent Training Dogs Was Compensable

The Federal Circuit Court of Appeals has affirmed an award of nearly \$300,000 in overtime compensation and liquidated damages under the Fair Labor Standards Act (FLSA) to canine enforcement officers (CEOs) of the Customs and Border Protection Service for unofficially assigned work that included laundering and processing towels used in dog training, construction of dog training aids, and other training activities [*Bull v. U.S.*, No. 2006-5038, 2007 U.S. App. LEXIS 5925 (Fed. CA, 3-15-07); see **PAYROLL CURRENTLY, Issue No. 3, Vol. 14**].

CEOs were required to conduct at least two training exercises with their dogs each day, and some Customs locations required more. To carry out this training, CEOs used scented towels to train dogs to recognize contraband odors. The towels were also used in games with the dogs to reward them for successfully detecting these odors. CEOs were required to launder and process the towels to remove residual scents so that they could be reused in training. In addition, CEOs were required to construct training

aids of varying complexity to mimic the containers in which contraband might be stored.

The court explained that the Customs Officer Pay Reform Act (COPRA), enacted in 1993, provides for double-time pay for “officially assigned” work in excess of 40 hours per week or in excess of eight hours in a day. Nothing in COPRA prevents a CEO from receiving overtime pay for work not “officially assigned” under some other provision of law. Thus, for overtime work that is not “officially assigned,” compensation under the FLSA is available. Here, the government did not argue that the overtime work in question was “officially assigned,” and the court applied the FLSA.

The Federal Circuit said the work in question, which was done outside normal working hours, was not *de minimis* and was therefore compensable. In particular, time spent laundering towels was time during which the officers were “engaged to wait” (which is compensable) rather than time “waiting to be engaged” (which is not compensable), because the CEOs’

activities were significantly limited by their need to monitor their running washers and dryers. The court also upheld the award of 1.5 hours per week of compensation for the time CEOs spent constructing training aids.

The Federal Circuit said that imposing a three-year statute of limitations was appropriate because the government’s violations of the FLSA were willful. Customs knew the CEOs were working off duty without compensation. An internal memo predicted that the work would lead to compensation issues for the agency. And the fact that Customs issued a memo in July 2004 directing that CEOs must have sufficient time and means during duty hours to launder towels and construct training aids was an admission that the agency knew it had potentially been violating the FLSA.

Moreover, said the court, liquidated damages were properly imposed because the government had knowledge of the CEOs’ circumstances but did nothing to address the situation until procedures were revised in 2004. **PC**

## Auto Mechanics Were Exempt Commission Employees

The Seventh Circuit Court of Appeals has affirmed that auto body technicians were not entitled to overtime pay under the Fair Labor Standards

Act (FLSA) because they were covered by the “retail or service establishment” exemption [*Yi v. Sterling Collision Centers, Inc.*, No. 06-2645, 2007 U.S. App. LEXIS

5760 (7th CA, 3-13-07)].

#### Background

Sterling Collision Centers, Inc. operates a chain of auto repair shops.

Customers are charged for repairs based on the number of hours normally required to do a repair (“booked hours”) multiplied by an hourly rate. This labor charge plus the cost of materials becomes the price paid by the customer for a repair.

The company assigns a team of mechanics to perform a repair job, and each member of the team tracks the hours he or she actually works. At the end of a job, Sterling determines each team member’s compensation by multiplying (1) the number of booked hours for the job by (2) the ratio of the team member’s actual hours worked to the total hours worked by the team, and then by (3) a wage, per booked hour (not an hour actually worked), based on the skill or quality of the individual team member.

**WHAT THE LAW SAYS** – In order to qualify for the retail or service establishment exemption (1) the employee must be employed by a “retail or service establishment”; (2) the employee’s regular rate of pay must

exceed 1½ times the minimum wage; and (3) more than half of the employee’s total earnings in a representative period must be commissions on the sale of goods or services (29 USC §207(i)).

The question in this class action lawsuit brought by Sterling auto technicians was whether they were paid on a commission basis.

#### **Ruling**

The Seventh Circuit said Sterling’s auto technicians were paid on a commission basis. The FLSA does not define “commission,” but the essential feature of commission compensation is that it is based on sales, which was the case here. Sterling’s compensation system was not based on actual time worked, but on the number of booked hours multiplied by each team member’s booked-hour rate. It was the equivalent of paying the repair team a percentage of the labor component of the price paid by the customer.

The fact that the mechanics worked in teams and that commissions were

allocated among them and divided did not alter their character as commissions. Nor did it matter that the allocation of commissions was weighted by quality, or that commissions were based on only part of the price paid by the customer.

The court pointed out that although the mechanics were paid by the job, they were not being compensated on a piecework basis. Piecework compensation is steady and depends on how fast the worker can work; however, an employee paid by the sale cannot count on steady work because sales depend on buyers’ decisions.

Finally, the court noted that Sterling’s compensation system was a longstanding method of payment used industry-wide. Although a longstanding industry practice may nevertheless violate the FLSA, “a more plausible hypothesis is that the auto repair industry has been left alone because the character of its compensation system has been recognized for what it is – a bona fide commission system.” **PC**



## STATE AND LOCAL NEWS

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**Kansas** Employers will receive Form K-CNS 100, *Quarterly Wage Report and Unemployment Tax Return*, for the first quarter of 2007 later than usual because of recently enacted legislation reducing unemployment insurance taxes for many employers. The Department of Labor plans to mail the forms between 3-28-07 and 4-3-07. As a result of this delay, no penalty or interest will be assessed on first quarter 2007 reports and taxes that are filed and paid by 5-18-07 [S.B. 83, L. 2007; DOL Announcement, 3-19-07].

**Texas** Effective 7-1-07, employers must file quarterly unemployment insurance (UI) reports (Form C-3, *Employer’s Quarterly Report*) by magnetic media or electronically if they have 10 or more (currently 250 or more) employees in any one calendar quarter (this updates *The Payroll Source*®, p. 7-37). An agent that reports on behalf of multiple employers and has to file reports on a cumulative total of 10 or more employees in any one calendar quarter must also file magnetically or electronically. Employers may file quarterly UI reports by using the Internet (C-3 Internet Filing), file upload (QuickFile), and magnetic media (tape, diskette, or CD). Visit the Texas Workforce Commission Web site at [www.twc.state.tx.us/ui/tax/c3.html](http://www.twc.state.tx.us/ui/tax/c3.html) for more information [40 Tex. Adm. Code 815.107; *Texas Business Today*, Winter 2007].

**Utah** Effective 4-30-07, magnetic media or electronic reporting is required for an authorized employer representative that files quarterly unemployment insurance (UI) reports on behalf of 100 or more employers during any calendar quarter (this updates *The Payroll Source*®, p. 7-37). Employers with 250 or more employees must submit UI wage information by magnetic media or electronically. For more information regarding online quarterly reports and payments, visit the Department of Workforce Services’ Web site at <http://jobs.utah.gov/ui/employer.asp> [H.B. 23, L. 2007].

**Virginia** Effective 7-1-07, employers with 100 or more employees and payroll processing firms with 50 or more clients must remit child support payments by electronic funds transfer (EFT). The Division of Child Support Enforcement offers a free program called “Virginia \$4Kids” that allows payments to be made through the Internet, <https://www.govone.com/vacs>, or a toll-free telephone number, 888-820-7280. For more information, visit <https://newhirereporting.com/va-newhire>, or contact Cheryl Parker, EFT Manager, at 804-726-7277 or [Cheryl.Parker@dss.virginia.gov](mailto:Cheryl.Parker@dss.virginia.gov) [S.B. 945, L. 2007].