A Timely Analysis of Legal Developments

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IRS provides advice that payments from clubs, bars and similar establishments to taxi drivers for steering patrons to such establishments are not tips from the taxicab companies but income from separate and distinct services. As a result, the establishments are required to report the payments on IRS Form 1099 if $600 or more.

IRS Issues Guidance on Distinguishing Tips and Other Third-Party Incentive Payments

By William Hays Weissman

In Chief Counsel Advice (CCA) 201106009[1] and 201106010,[2] the Internal Revenue Service (IRS) determined that amounts paid by adult entertainment clubs, bars and other establishments to taxicab drivers who deliver passengers to the establishments are income to the drivers, not tips received by the drivers in the course of their employment with taxicab companies. Rather, the payments are for services separate and distinct from the drivers' employment, and thus the establishments making the payments are responsible for issuance of Form 1099 to the drivers.

Background

The taxi drivers at issue are employees of taxicab companies engaged in the business of transporting passengers for a metered fare. The cabs are equipped with meters that calculate and display the fares for any transportation. The drivers pick up and transport passengers to their requested destinations. Typically, the driver collects the fares from the passengers, and the meter fare is split between the driver and the taxicab company. It is customary for the passengers to tip the drivers an amount in addition to the meter fare for the transportation provided.

Some adult entertainment clubs (and other establishments) have a practice of making payments to taxicab drivers who bring passengers to their establishments. Generally, the club personnel will not render payment to the driver until the passengers first pay a cover charge or otherwise indicate in some manner that they are patrons of the club (such as purchasing drinks or drink tickets). Payments are usually made in cash, although some clubs issue vouchers to the drivers that can be exchanged for cash at a later time. The amount of the cash or voucher payment may or may not bear any relationship to the meter fare, may vary depending upon the number of passengers, and may be far greater than either the metered fare or the customary tip for the transportation. Typically, one or more passengers are transported from a hotel directly to a club. In some cases, the driver may make agreements with certain hotel personnel so that when a guest wants to go to a club, the hotel personnel will summon the driver's taxicab from the queue at the hotel and the driver will split the payment from the club with the hotel personnel. In some cases, the passenger may not request a particular

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destination and the driver or hotel personnel will recommend a club that will pay an amount for delivering the passenger/club patron. Several clubs and other establishments advertise in a local magazine, specifically targeted at drivers in the transportation industry, that they will pay a "referral fee" or "tip" or "incentive" for delivery of passengers/patrons.

The CCA's Legal Reasoning

The clubs have not been reporting the referral fees as income to the drivers, contending they should be reported by the taxicab companies as "tips." The taxicab companies have not been reporting the income, contending that the referral fees are not tips earned in the course of employment for the cab companies.[3] Guidance was requested on three questions:

1. Whether the payments are income to the drivers?
2. Whether the payments are tips for services the drivers perform as employees of the taxicab companies (tips in the course of employment) or are payments for separate and distinct services?
3. What reporting requirements apply to the payments?

On the first question of whether the referral fees were income, the IRS found that the referral fees were clearly income to the drivers under Internal Revenue Code section 61, which defines *income* broadly to include "all income from whatever source derived." It also noted that under the regulations tips must be included by the recipient in his gross income.[4] Thus, the referral fees were "income" to the drivers regardless of whether they were "tips" or a "referral fee" for services distinct from their employment.

On the second question of whether the referral fees were actually "tips," the IRS found that they were not. While acknowledging that there is no definition of a "tip" in either the Internal Revenue Code or regulations, the IRS did rely upon a 1959 Revenue Ruling[5] that sets forth four factors used to determine whether a payment constitutes a tip or service charge. The Ruling found that the absence of any of the following factors creates a doubt as to whether a payment is a tip and indicates that the payment may be a service charge:

- the payment must be made free from compulsion;
- the customer must have unrestricted right to determine the amount thereof;
- the payment should not be the subject of negotiation or dictated by employer policy; and
- generally, the customer has the right to determine who receives the payment.[6]

While stating that all facts and circumstances must be considered when determining whether a payment constitutes a "tip," here the facts supported characterizing the payments at issue as "for the drivers' separate and distinct service of referring patrons, influencing patrons and delivering patrons to particular clubs, rather than merely transporting passengers as part of their duties for their employers, the taxicab companies."[7] The IRS found significant the fact that payments from the clubs were contingent upon the "passenger" becoming a "patron" of the club, which it said "illustrates that the payment is made for the separate service of delivering a patron rather than transporting a passenger."[8] It also found supportive the facts that the clubs were not actually the recipients of the transportation and that drivers frequently recommended specific clubs in order to secure payments.[9] Therefore, the IRS concluded that the referral fees were not "tips" received in employment.

Turning then to the last question of whether the clubs must report the income, the IRS unsurprisingly found that they must. "Because the payments at issue are for separate and distinct services of delivering patrons to the clubs, the clubs are required under Internal Revenue Code section 6041 to file a Form 1099 with the IRS for each taxicab driver to whom they paid $600 or more during the calendar year."[10] The IRS added that "If the clubs do not file Form 1099, whether they are subject to penalties under I.R.C. § 6721 depends on the facts and circumstances."[11]

While not mentioned in the analysis, these CCAs are arguably consistent with prior IRS guidance. For example, the IRS previously had opined that, when a manufacturer pays a bonus to salespeople working for a retailer to get them to "push" its products, the bonus is not wages because it is being paid by a third party that is not the salesperson's employer. As such, the payments are income to the salespersons, but not subject to income tax withholdings or employment taxes.[12]

While the IRS analysis seems entirely reasonable, in many jurisdictions taxi drivers operate as independent contractors, not employees. Thus, the distinction between whether the payments are tips for services in employment or referral fees for distinct services would be irrelevant. In either case, the payments would be self-employment income to the taxi driver that the driver is obligated to report. Nonetheless, the IRS analysis may also have been a somewhat result driven effort to compel clubs, bars and other establishments to report such payments for purposes of ensuring that the drivers are properly reporting their income from all sources. Either way, these CCAs should serve as a reminder to entities that make payments to third parties' employees of $600 or more that they should report the payments as nonemployee compensation on an IRS Form 1099, or else risk penalties for failing to do so.

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[1] CCA 201106009, Apr. 28, 2010. This CCA was released by the IRS on February 11, 2011.

[2] CCA 201106010, Dec. 1, 2010. This CCA was also released by the IRS on February 11, 2011. The December 1, 2010, CCA was a follow up to the April 28, 2010, CCA, but both addressed the same issues and reached the same general conclusions.

[3] The IRS pointed out that some of the taxicab companies had tip reporting agreements with the IRS, and that there was no indication that the referral fees at issue were considered as part of the tip reporting agreements.

[4] Treas. Reg. § 1.61-2(a)(1).

[5] Rev. Rul. 59-252, 1959-2 C.B. 215.

[6] CCA 201106010, at 3. The IRS noted that several courts have addressed the question of whether a payment was a "tip" from a gift perspective. For example, it cited to a Ninth Circuit case, stating:

> In *Roberts v. Commissioner*, 176 F.2d 221 (9th Cir. 1949), the Ninth Circuit, in considering whether tips to an employee taxi driver from customers were taxable income, recognized that tips "lacked the essential element of a gift,- namely, the free bestowing of a gratuity without consideration." *Id*. at 223. Furthermore, the court noted that "a tip is connected directly with the service and its quality." *Id*. at 224. The taxpayer "received tips as an incident to the service which he rendered to his patrons." *Id*. at 226.

Id. at n. 3.

[7] *Id*. at 4.

[8] *Id*.

[9] *Id*. The IRS added: "Certainly, in cases where a passenger requests a particular destination and the driver tries to persuade the passenger to go to a different destination because of the payment the driver expects to receive, the purpose of the payment for these separate services becomes even more apparent; however, this fact is not necessary to our conclusion that drivers are providing services that are separate and distinct from transporting passengers." In CCA 201106009, the IRS reached a similar conclusion, but also noted that "If the passenger requests a particular destination, and the driver acquiesces without comment when he knows that the establishment will pay him for delivering the passenger, the payment looks more like a tip for performing only the transportation service the passenger requested." CCA 201106009, at 4.

[10] CCA 201106010, at 5-6.

[11] *Id*. at 6.

[12] This is commonly called "push money." *See, e.g*., Rev. Rul. 70-337,1970-1 CB 191; Rev. Rul. 70-331,1970-1 CB 14.