What Employers Need to Know About Tip Reporting

By **John Nessel**
Restaurant Resource Group

Tip Reporting 101

As if the restaurant business was not hard enough, complying with IRS tip reporting rules is one of the most critical and important tasks facing restaurant owners! This is truer today than a decade ago as the IRS is accelerating its efforts to capture previously lost revenue in the form of income and FICA (Social Security & Medicare) tax. As a restaurant owner you should therefore be aware of your responsibilities regarding the reporting of your employee's tips.
The bottom line is this... restaurant employees are required to report and pay taxes on all their wages including tips. Since most tipped employees receive a majority of their income in the form of "cash" tips, it is no wonder that they are reluctant to fully report this income. It is one of the reasons that working as a waiter in full service restaurant can be so appealing. Where else can many of these folks make a hundred plus dollars in cash for five or six hours of work? To make matters worse the restaurant owners are thrust in the middle because they are responsible for withholding Federal and State income tax from employee wages as well as the FICA tax. So the employer and employee are both caught up in the same conundrum, and each has its own tip-reporting responsibilities.

Three Things An Employer Needs to Know

From the Employers perspective here are the three basic things that you need to know if you employ tipped workers:
1. You need to receive a" tip report" from each employee for every payroll period. While the IRS requires tipped employees to provide this report once a month, you will need a report for every payroll period, otherwise you cannot correctly report the employee's total wages, nor can you withhold the proper taxes (and pay your share of FICA tax). You can use your POS system to collect this information at the end of each shift by requiring tipped employees to "input" their cash tips prior to "clocking out" (charged tips are already captured when guest checks paid by credit card are closed). Alternatively you can use the IRS created Form 4070A "Employee's Daily Record of Tips" (http://www.irs.gov/pub/irs-pdf/p1244.pdf) or use any other form you like so long as it includes:

- **Employee's name, address and SS number**
- **Employer's Name**
- **Period Covered and Date Reported**
- **Total Amount of Tips Received by the Employee, and the**
- **Employee's Signature**

2. You need to withhold Income and FICA tax from each paycheck, and report each employee's tips to the IRS. Assuming that you use a payroll service to process your payroll, you will need to report the total tips reported for the payroll period as submitted to you by that employee, along with the tipped employee's hours and hourly rate. This information will also be included on your "Employers Quarterly Payroll Tax Return" (Form 941) that is filed by you or your payroll service. At the end of the year you will also need to account for each employees total wages (including tips) on their W2. In certain cases you may need to "allocate" additional wages for an employee if he or she has failed to report "sufficient" tip income (more on this in the next section)

As a practical matter you cannot force your employees to report all their tip income, and be assured, they will not! While you are legally responsible for distributing Form 4070A (or an acceptable alternative) the restaurant is only liable for its share of the FICA taxes on unreported tips (and only if the IRS is successful at substantiating unreported tip income). While that may sound to you like an acceptable risk to take, just think of the liability that might accrue over a year or more if such an audit were to take place. Many restaurants would be out of business! You simply should not take that risk. You must therefore take a pro-active role in educating, prodding, cajoling, and annoying, if necessary, your employees to get them to accurately report their tips.

3. You need to file IRS Form 8027 at the end of each year. It summarizes the restaurants total sales, charged sales, charged tips and total reported tips. So long as tipping is customary in your restaurant, food and beverages are served, and more than ten employees are normally employed, then you must submit the "Employers Annual Information Return of Tip Income and Allocated Tips" on an annual basis (http://www.irs.gov/pub/irs-pdf/f8027.pdf).

Now here is where it gets "dicey". This report is organized in such a way as to highlight any shortfall of reported tips below 8% of gross receipts from food and beverage sales. This line item is like a "flashing red light" to the IRS indicating that your employees may not be reporting all their tips. In fact, if your total reported tips are less than 8% of total food and beverage sales, then you must **allocate additional tip income** to the W2 of every tipped employee that reported less than 8% of their respective sales, so that their total reported income reflects this minimum 8% allocation.

There are three methods of allocating additional employee tips: 1) hours worked, 2) gross receipts, or 3) a good faith agreement.

The **Hours Worked method** applies only to restaurants which employ fewer than 25 full time employees during a payroll period, and it allocates any tip shortfall (below 8% of total sales) by spreading it among underreporting servers based on their percentage of total hours worked as compared to all the other servers. This method is the least accurate as it does not take into account the fact that servers work shifts with different tipping patterns.

The **Gross Receipts method** can be used by any restaurant and usually results in a more accurate and fair allocation. It determines the amount that each server should have reported in tips to reach the 8% minimum threshold by comparing the server's gross receipts as a percentage of the total restaurant receipts. If the server's actual reported tips are less than the percentage calculated as above then a prorate portion of the total shortfall is allocated to that employees W2.

The **Good Faith Agreement** method is rarely used and is not worth explaining.

For a detailed explanation of each method click on http://www.irs.gov/pub/irs-pdf/i8027.pdf.

The 8% Myth

Don't be misled by the 8% figure that is used in the Form 8027 discussed above. Just because this is the "threshold" number that the form uses to require you to allocate additional tip income does not mean that this is all you need to report to be safe from an IRS audit. The law requires your employees to report 100% of tip income and the 8% threshold is only **one way** that the IRS monitors compliance and flags under reporting restaurants.

If you have a POS system that tracks server sales by employee than it is easy (though time consuming) to see if your servers are accurately reporting their tips. Your POS should report each server's total credit card sales and total charged tips on credit cards, and the server's total sales (cash and credit card). From the credit card information you can get a tip percentage to apply to the server's cash sales. Combine the total credit card tips and the estimated cash tips for the period in question and compare this total to the tips reported by the employee.

IRS Tip Agreements

As a result of the significant under reporting of restaurant tip income; the IRS has been trying to get the support of restaurant owners. In order to gain their cooperation they have come up with an offer that, in effect, says that the IRS will not bill the restaurant for FICA taxes due as a result of tip under reporting **unless it has first examined all your employees who have under reported**.

This issue of the IRS's right to bill restaurants for underpaying FICA tax without first auditing the employees who are directly responsible, has caused a major legal battle currently being played out in the courts. In July of 2002, the U.S. Supreme Court ruled against restaurants by upholding the IRS's ability to estimate the amount of cash tips given to employees based on the restaurants credit card tips. This "employer only" and "employer first" approach by the IRS is therefore the motivating factor that encourages owners to sign tip agreement contacts. You can follow the public policy discussion by clicking on these links:http://www.restaurant.org/government/tipaudits.cfm and http://www.restaurant.org/legal/tips/legal.cfm

The tip agreement form or contract is called **TRAC** (Tip Reporting Alternative Commitment), and under it a restaurant agrees to assume greater responsibility for getting its employees to fully report their tips. Another alternative called EmTRAC permits the restaurant owner to develop a contract for achieving the same end. Either way, the TRAC agreement commits the employer to:

1. Educate the Employees about Tip Reporting
2. Establish Tip Reporting Procedures, and
3. Keep Up With All Tax Payments and Filing Obligations

For additional information on TRAC agreements check out this National Restaurant Association link:http://www.restaurant.org/legal/tips/agreements.cfm.

You can also purchase a Tip Reporting Education Kit from the NRA which includes employee brochures, posters, sample payroll stuffers and a Quick Tips wallet card at http://www.nrahef.org/products.asp?cat=2&sctcode=11.

Finally, for more information on this subject as well as hospitality & restaurant tip and gratuity compliance solutions and answers visit GrataSoft.com and TipCompliance.com.