

## The Tip Police

### What Happens to Waitstaff Now That the IRS Can Estimate Tips?

The Supreme Court ruled that the Internal Revenue Service may use estimates to make sure it's collecting enough taxes on "cash" restaurant tips. As expected, restaurant industry officials vehemently opposed the decision claiming it may put some restaurants out of business by pitting restaurateurs against their employees.

#### Allocated Tips - Background

Employees are required to report tips of \$20 or more per month to their employers. Employers are then required to withhold social security and Medicare taxes on the reported tips. For certain establishments, employers are also required to verify the tips reported by employees.

The allocated tip rules apply when all of the following conditions exist:

1. Food or beverages are provided for consumption on the establishment's premises
2. Tipping is customary
3. More than 10 people are employed on a typical business day
4. Total tips reported are less than a required minimum percentage (generally eight percent) of total food and beverage sales.

If the percentage of total reported tips is less than a required minimum percentage of gross sales, the employer must allocate an additional amount of tips to its employees. Employees who report less than the expected amount of tips are allocated an additional amount of tip income.

These employees report allocated tips as wage income and pay their share of the social security and Medicare tax liability.

**Example.** A restaurant has credit card sales of \$100,000 with tips of \$15,000. Based on this information, it is assumed that all customers tip 15 percent. Employees who have reported less than 15% of sales as tips are allocated an additional amount.

**// In 2002, the Supreme Court ruled that the IRS could use estimates to make sure its collecting enough taxes on cash tips; t has angered the estimated 200,000 restaurants with tipped workers. Some restaurateurs believe the ruling could eventually put them out of business. //**

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#### The Supreme Court

In the decision involving a large restaurant in San Francisco<sup>1</sup>, the Supreme Court ruled that the IRS has the right to estimate cash tips paid to restaurant employees based on tips shown on credit card receipts. The Court also held that the employer's share of social security and Medicare taxes can be determined based on the estimated tips. This ruling overturned the Circuit Court decision, which had been in the restaurant's favor.

Restaurant owners have argued that only an employee-by-employee audit can properly determine allocated tips and the

employer's tax liability. In the Fior d'Italia case, the restaurant owners argued that the aggregate estimation method used by the IRS lends itself to "abusive agency action." While the Ninth Circuit Court agreed with these arguments, the Supreme Court concluded that the IRS acted within its authority and within the meaning of the tax code.

As a result of the ruling, the Ninth Circuit Court has remanded its prior ruling.

<sup>1</sup> Fior d'Italia, Inc. v U.S., (CA9 3/7/01) 87 AFTR 2d 2001-1118

## What You Need to Do

**Employees.** Employees should keep contemporaneous, written logs of tip income and report all tip income to their employer. If you allocated tips, you generally must complete Form 4137 to pay in your share of employment taxes on those tips. If you can prove that you reported all of your tips, you can attach a statement to your return stating that you are not filing Form 4137 because you have records to substantiate the amount of your tips.

**Employers.** The IRS has implemented the TRAC program (Tip Reporting Alternative Commitment), a voluntary tip-reporting program that assists restaurant owners in educating employees about reporting and tracking tips. For more information, go to the IRS website at <http://www.irs.gov/businesses/small/industries/article/0,,id=98367,00.html>