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An Analysis of Recent Developments & Trends

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Dealing With Employees' Tip Income In Large Food and Beverage Establishments: New IRS Agreement ("ATIP") Available January 1, 2007

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Summary: Large food and beverage employers must understand how to deal with employees' tipped income. The IRS recently announced a new program to assist with employers' and employees' compliance obligations. This Insight reviews tip reporting obligations and IRS programs to assist with those obligations.

Introduction

Employers that have a lot of tipped employees, such as restaurants and casinos, often face a host of employment law challenges, including payroll challenges. Under the Internal Revenue Code (Code), tips are income subject to income tax withholding and usually subject to Social Security and Medicare taxes as well. Problems often arise when the employer does not know exactly how much tip income an employee receives because of cash tips or because the employees, such as hosts or bussers, are indirectly tipped by other employees, such as waiters.

To help employers with these issues, the Internal Revenue Service (IRS) has developed several programs designed to reduce the potential negative tax consequences for employers of employee underreporting or misreporting of tip income. While these programs do not alter the legal requirements regarding the taxation of tip income, they are designed to help reduce compliance burdens and opportunities for error. This summer the IRS also announced a new program, set to begin on January 1, 2007.

This Insight offers employers a short guide for dealing with the federal taxation of tipped employees and the IRS' compliance programs.

Employers' and employees' obligations with respect to tip income

A. Tips are income subject to income tax withholding and payroll taxes

The Code clearly requires that tips be treated as income subject to tax. Thus, tips are subject to income tax withholding by the employer, as

well as FICA taxes paid by the employees and employer and employer-paid FUTA taxes.

B. Employees' obligations to report tips to the employer

If an employee earns more than \$20 in tip income in a month from a single employer, then the entire amount of the tip income is subject to Social Security and Medicare taxes. An employee is obligated to report the amount of all tips to his or her employer. Employees can use Form 4070A, *Employee's Daily Record of Tips*, to keep a daily record of their tips and Form 4070, *Employee's Report of Tips to Employer*, to report their tips to their employer. Both of these forms are contained in Publication 1244, *Employee's Daily Record of Tips and Report to Employer*.

Employees cannot deduct amounts tipped out to others on their tax returns. However, IRS Forms 4070 or 4070A allow employees to report both the amount of tips received and the amount of tips tipped out to others. This allows for the calculation of the net tip to the employee for tax purposes.

Failure to report tips can result in a penalty equal to 50 percent of the Social Security and Medicare tax owed, in addition to the tax. Tips are deemed paid to an employee when the employee furnishes the report to the employer. However, if no report is made, then tips are "paid" when received from the customer or remitted by the employer, such as in the case of charged tips.

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C. Large Food and Beverage Establishments' Obligations

An employer that has 10 or more employees on a typical day and serves food or beverages consumed on premises is designated a "large food or beverage establishment." These employers are required to allocate tips to employees if total tips reported by employees are less than 8 percent of gross sales.

However, irrespective of the amount of tips, large food or beverage employers are required to fill out IRS Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips*. Form 8027, which must be filed by February 28 each year (unless it is filed electronically, in which case it can be filed by March 31), requires the employer to report its total gross food or beverage receipts, charges and reported direct and indirect tips. Each separate establishment must file its own IRS Form 8027 even if owned by the same person or entity.

Taxes on tips should generally be withheld from an employee's regular wages. If taxes exceed available wages, the employer can ask the employee for funds to satisfy any withholding obligation. If there are insufficient funds then available, wages should be prioritized:

- *First*, withhold all taxes due on regular wages.
- *Second*, withhold Social Security and Medicare taxes due on reported tips.
- *Third*, withhold any federal, state or local income tax on reported tips.

Both withheld funds and uncollected amounts are reported on the employee's W-2. Withheld amounts are reported for Social Security in box 4 and Medicare in box 6, while uncollected amounts are reported in box 12, with Code "A" for Social Security and "B"

for Medicare. Even if the employee fails to provide sufficient funds, the employer is expected to remit its full share of taxes. An employer can withhold any remaining unpaid taxes from the employee's next paycheck. An employer should also show the uncollected amount as an adjustment on IRS Form 941, *Employer's Quarterly Federal Tax Return*. Employers report tips in box 8 of the employee's W-2.

IRS efforts to address issues concerning tipped employees

In *Fior D' Italia v. United States*, 536 U.S. 238 (2002) the United States Supreme Court held that the IRS could assess a restaurant for FICA taxes based upon an aggregate estimate of all the tips that the restaurant's customers paid its employees rather than what was reported by its employees. Fior D' Italia restaurant (which is the nation's oldest Italian restaurant, established in San Francisco in 1886) paid FICA taxes based on the tip amount its employees reported. A compliance check by the IRS revealed that charged tips far exceeded the amount of reported tips. The IRS thereafter used the "aggregate estimation" method to determine an average percentage tip based on the charges, and assessed both charged tips and cash tips at the same aggregate rate. It then applied that aggregate rate to Fior D' Italia's total receipts to determine the amount of FICA taxes that should have been paid by the restaurant, and issued an assessment for the difference between what was reported and the aggregate rate.

Justice David H. Souter filed a dissent, joined by Justices Antonin Scalia and Clarence Thomas, stating that the aggregate method used by the IRS "raises anomaly after anomaly, to the point that one has to suspect that the Government's practice is wrong." Nonetheless, as a result of *Fior D'Italia*, the IRS has been given broad authority to issue assessments based on fairly simplistic

estimates of what tips should have been reported.

The IRS has recently begun to increase its audit activity with respect to tipped employees. It has put in place a mechanism to identify employees that are underreporting tips relative to tips reported by employers when employees' W-2 tips do not match the tips reported by the employer. Thus, employers should be concerned about ensuring that employees are properly reporting tips.

However, the IRS is not completely unaware of the potential trap that employers are placed in with respect to dealing with tipped employees, having the obligation to withhold and pay taxes but not always having knowledge of or control over the income. Thus, the IRS created several programs to help alleviate this potential whipsaw.

Tip reporting agreements for the food and beverage industry

The IRS formed the Tip Rate Determination/Education Program in 1993 as a pilot program. Given its success, the IRS continued it indefinitely in 2004.

There are four kinds of tip reporting agreements for the food and beverage industry:

- Tip Rate Determination Agreement (TRDA);
- Tip Reporting Alternative Commitment (TRAC);
- Employer-designed TRAC (EmTRAC); and
- Attributed Tip Income Program (ATIP) (effective January 1, 2007).

The first three kinds of agreements have some common features. For example, they require the employer to enter into a written agreement with the IRS, usually for three years, for each specific establishment. Thus, an employer that owns several different restaurants will need several agreements.

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These agreements also generally have specific compliance requirements on the part of the employer, and allow the IRS to conduct compliance audits. Importantly, they limit audits of the establishment under Code section 3121(q), and generally only allow audits based on employee audits or IRS Form 4137, which an employee files with his or her 1040 to report unreported tip income.

1. TDRA

In addition to general requirements stated above, the TRDA also has several specific requirements:

- Requires the IRS to work with the employer to arrive at a tip rate for each occupation at the establishment (e.g., busser, waiter, bartender, etc.).
- Requires the employee to enter into a Tipped Employee Participation Agreement (TEPA) with the employer.
- Requires the employer to get 75 percent of the employees to sign TEPA's and report at or above the determined rate.
- Provides that if employees fail to report at or above the determined rate, the employer will provide the names of those employees, their social security numbers, job classification, sales, hours worked, and amount of tips reported.
- Does not require any specific education requirement for employees.
- Participation assures the employer that prior periods will not be examined as long as participants comply with the requirements under the agreement.

In 2003, the IRS announced a version of the TDRA for casinos, called the "Gaming Industry Tip Reporting

Compliance Agreement" ("GITCA"), via Revenue Procedure 2003-35. The GITCA is similar to the TDRA, although there are a few differences. For example, only 50 percent of employees must opt in for it to be effective. Also, for food and beverage establishments within a casino, IRS Form 8027 is not required so long as occupation, shift and hours are reported for all employees.

2. TRAC

Similar to the TDRA, the TRAC has specific additional requirements beyond the general requirements stated above:

- Requires the employer to establish a procedure where a directly-tipped employee is provided (no less than monthly) a written statement of charged tips attributed to the employee. In contrast to the TDRA, the TRAC does not require that a tip rate be established between the IRS and the employer.
- Implement a procedure for the employees to verify or correct any statement of attributed tips.
- Adopt a method where an indirectly-tipped employee reports his/her tips (no less than monthly).
- Establish a procedure where a written statement is prepared and processed (no less than monthly) reflecting all cash tips attributable to sales of the directly-tipped employee.
- Does not require an agreement between the employee and the employer, but 100 percent of employees are covered.
- Provides that if the employees of a business collectively underreport their tip income, tip examinations may occur but only for those employees that underreport.

- Requires a commitment by the employer to educate and reeducate quarterly all directly- and indirectly-tipped employees and new hires of their statutory requirement to report all tips to their employer.
- Participation assures the employer that prior periods will not be examined as long as participants comply with the requirements under the agreement.

3. EmTRAC

The EmTRAC is essentially the same as the TRAC, except that employers are given much greater latitude in designing the educational programs and tip reporting procedures.

4. ATIP

The ATIP program was just released by the IRS this summer. It is a three-year pilot program for food and beverage employers. Employers may participate on an annual basis beginning January 1, 2007.

Employers receive significant benefits by participating in the ATIP:

- The IRS will not initiate an "employer-only" 3121(q) examination during the period the employer participates in the ATIP.
- Tip reporting is simplified, and in many cases employers will not have to receive and process tip records from participating employees.
- Enrollment is simple. There are no one-on-one meetings with the IRS and no agreements to sign. Employers elect participation in the ATIP by checking the designated box on Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips.
- If employers have already signed a TDRA or TRAC agreement, checking

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the box on Form 8027 to elect into the ATIP simply converts their agreement to an ATIP agreement.

Employees also benefit from the ATIP:

- Participating employees do not have to keep a daily tip log or other tip records.
- The IRS will not initiate a tip examination during the period the employer and employee participate in the ATIP.
- The improved income reporting procedures could help employees qualify for loans or other financing.
- Employees who work for a participating employer can easily elect to participate in the ATIP by signing an agreement with their employer to have their tip income computed under the program and reported as wages.

Some general requirements for participating restaurants:

- The employer annually elects to participate in the ATIP and uses the prescribed methodology for reporting tips by filing Form 8027 and checking the ATIP participation box. Simplified filing is provided for small establishments not required to file Form 8027.
- Employer's establishment must have at least 20 percent of gross receipts as charged receipts that reflect a charged tip.
- At least 75 percent of tipped employees must agree to participate in the program.
- Employer reports attributed tips on Employees' Forms W-2 and pays taxes using the formula tip rate.
- The formula tip rate is the charged tip rate minus two percent – the two percent takes into account a lower cash tip rate.

- The charged tip rate is based on information from the establishment's Form 8027.

Strategies for dealing with the tax issues associated with tipped employees

Because employers generally cannot direct employees' activities with respect to their income, and thus cannot demand that income be turned over to be counted or specify the exact pay-out to indirectly-tipped employees, employers face challenges when attempting to ensure that tips are correctly reported. Nonetheless, there are some actions employers can take to better ensure that employees are in compliance with their reporting obligations, so that employers can properly meet their obligations.

- Keep stacks of IRS Forms 4070 and 4070A on hand, encourage employees to fill them out at the end of each work day, and keep the completed forms in a folder on site.
- If possible, enter into a tip reporting agreement. Determine which kind of agreement is most appropriate given the size and nature of the workforce.
 - For example, the TRDA establishes tip rates in advance, while the TRAC relies more on voluntary compliance for reporting purposes. Based on the nature of the establishment and the workforce, one method may be more desirable.
 - However, the new ATIP program may be superior to the TDRA, TRAC and EmTRAC programs because of its simplicity, reduced paperwork requirements, and protections against audit. Entering into the ATIP might also eliminate the need to implement many of the other recommendations stated herein, such as the recordkeeping requirements for employees.
- Provide periodic reminders and training

on proper reporting obligations. Because employees sometimes stop listening to their employers, bring in outside advisors on occasion, such as the corporate HR director, outside counsel or even the IRS, to discuss these obligations.

- Conduct periodic "reality checks" to determine whether reported tips appear reasonably consistent with the amount of tips appropriate to the kind of establishment at issue.
- Encourage employees to provide the employer extra funds if it appears that they will not have enough money withheld to pay taxes.
- If allowable under state law, deduct credit card processing fees from charged tips and only report the net to employees and for tax purposes.
- Assist employees with their tax reporting obligations.
- Contact tax counsel if you have any questions or concerns about reporting obligations.

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