Ep. 24: Reporting Cash Tips to the IRS

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In restaurants, the wait staff, bartenders, and bussers are required to report their tips, including cash tips, to the restaurant and the IRS. Even if these employees fail to report cash tips to the restaurant, the IRS can tax the restaurant on the unreported cash tips.

Hello. I'm **Douglas Charnas**, Member in McGlinchey's Washington, DC office. I practice Tax law, and over the years have represented a number of restaurant owners in IRS tax examinations.

Few, if any, industry has been as adversely affected by the coronavirus pandemic as the restaurant industry. Although we are emerging from the restrictions caused by the pandemic, restaurants are struggling to survive and there is little time to worry about tax issues. But while the pandemic has created many uncertainties, taxes and the IRS are certain. That is why I want to take a few minutes of your time today to talk about an important tax issue for restaurants.

As we all know, the IRS has great power to tax. Among those powers is the power to make a restaurant pay the employer's share of FICA (Federal Insurance Contributions Act) tax on cash tips the employees receive but do not report to the restaurant. Even though the employees may pocket the cash tips and say nothing to the restaurant about them, the restaurant may still be required to pay the employer's share of FICA tax on the unreported cash tips.

You ask, how can this be? How can I be taxed on something I don't even know exists? Well, the starting point is that cash tips are income and must be reported. Not only are they income, but they are subject to employment tax. The restaurant is required to pay the employer's share of FICA tax and the employee is required to pay the employee's share of FICA tax, as well as income tax. It is no surprise, however, that many cash tips go unreported. Some estimates put the amount of [tax] not collected annually because of unreported tips in the billions of dollars. This tax gap - that is, the difference between the taxes that should be collected and taxes that are collected – has been the focus of both IRS and Congress for many years.

Even if cash tips are subject to tax, how does the IRS know there are unreported cash tips? The IRS will not know the exact amount of unreported cash tips, but a 2002 U.S. Supreme Court case held that the IRS has the authority to estimate the amount of cash tips subject to tax.

In *United States v. Fior D'Italia, Inc.*, the Supreme Court held that the IRS is authorized to use an aggregate estimation method when a restaurant underreports its tip income, and that restaurants could be held liable for taxes beyond what their individual employees reported for tips. The aggregate estimation method uses overall credit card charges to determine the average percentage tip rate paid by the customers. This rate is then applied to the total sales reported to estimate unreported cash tips.

To give the IRS information it needs to use the aggregate estimation method, and for other reasons, restaurants with more than 10 employees on a typical business day and meet certain other requirements are required to annually file IRS Form 8027, which is titled “Employer’s Annual Information Return of Tip Income and Allocated Tips.” Information that is reported on Form 8027 includes total charged tips, total charged receipts showing charged tips, and total gross receipts. The IRS uses this information to estimate the amount of cash tips received and compares this amount to cash tips reported to estimate unreported cash tips.

In a recent IRS examination of a national restaurant chain that I handled, the IRS agent first determined the average tip percentage for tips reported on credit card sales. He then reduced that amount by 2% for a tip percentage rate for cash transactions, because tips on cash transactions are historically lower than tips on credit card transactions. He also assumed that no tip would be left for 5% of total cash transactions (what he referred to as the “stiff factor”). Using this information, he determined the amount of unreported cash tips and the employer’s share of the FICA tax attributable to the unreported cash tips. This resulted in a seven figure tax liability for the restaurant chain.

The Internal Revenue Code provides an income tax credit for the FICA tax the restaurant has to pay on the unreported cash tips, but the restaurant may not be able to utilize this credit. This is particularly true given that many restaurants likely will have little, if any, taxable income for 2020 and 2021.

Well, how can a restaurant stop the IRS from taxing it for the employer’s share of FICA tax on unreported cash tips? The good news is that a restaurant can participate in one of two IRS voluntary programs that substantially reduce the likelihood that a restaurant will be taxed on unreported cash tips. Under either program, the restaurant signs an agreement with the IRS. The two agreements are the Tip Rate Determination Agreement (TRDA) and the Tip Reporting Alternative Commitment (TRAC). The TRAC agreement is commonly referred to as the TRAC agreement, and tends to be the more popular of the two agreements.

A restaurant can participate in one of two IRS voluntary programs that substantially reduce the likelihood that a restaurant will be taxed on unreported cash tips. The two agreements are the Tip Rate Determination Agreement (TRDA) and the Tip Reporting Alternative Commitment (TRAC).

The Tip Rate Determination Agreement requires the determination of tip rates using historical data that the IRS works with the restaurant to establish. Employees are required to sign an agreement with the restaurant that they will report tips at or above a determined rate established by the restaurant and the IRS. Under the TRDA, the restaurant reports non-compliant employees to the IRS, but it is not required to educate the employees on reporting tips.

The Tip Reporting Alternative Commitment, or TRAC agreement, does not require that a tip rate be established or that the restaurant enter into an agreement with its employees, but it does require the employer to:

1. establish a procedure where a directly-tipped employee is provided (no less than monthly) a written statement of charged tips attributed to the employee;

2. implement a procedure for the employees to work to verify or correct any statement of attributed tips;

3. adopt a method where an indirectly-tipped employee reports his or her tips (no less than monthly). This could include a statement prepared by the employer and verified or corrected by the employee; and

4. 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.

The TRAC agreement includes a commitment by the restaurant to educate and reeducate quarterly all directly and indirectly tipped employees and new hires of their statutory requirement to report all tips to the restaurant.

The TRAC agreement also requires the restaurant to notify the IRS each time it opens a new restaurant location. If it fails to notify the IRS of a new location, that location is not covered by the TRAC agreement.

The key benefit of either TRDA or TRAC participation is that participation assures the restaurant that prior periods will not be examined as long as participants comply with the requirement under the agreement. This means the IRS will not tax the restaurant for unreported cash tips.

The law imposes responsibilities on employees as well. Restaurant employees who receive tips must do three things, regardless of whether the restaurant participates in a TRDA, a TRAC, or neither. First, the employee must keep a daily tip record. Second, the employee must report tips of $30 or more per month to the restaurant. Finally, the employee must report all tips on the employee’s individual income tax return.

Tipped employees can use IRS Publication 1244, which is titled “Employee’s Daily Record of Tips and Report to Employer,” to record tip income. Publication 1244 includes Form 4070, “Employee’s Report of Tips to Employer,” and Form 4070A, “Employee’s Daily Record of Tips.” These forms have spacing to log the employer’s name and address, date tips were received, date of entry, cash and charged tips received, tips paid out, and the employee paid.

As restaurants begin to fully reopen, business will likely boom. Everyone is eager to return to life as it was before the pandemic. Before business becomes overwhelming, it is useful to take few minutes to think about the tax issue presented by unreported cash tips, and how to reduce the potential for IRS to tax the restaurant on unreported cash tips. The pandemic has raised many challenges, particularly with respect to taxes. McGlinchey will continue to provide tax and other legal updates relating to the pandemic as they developed. Thank you for joining us today.

Thanks for tuning into this episode of "More with McGlinchey." If you have a question or would like to propose a topic, we'd love to hear from you at podcast@mcglinchey.com. For additional resources on this topic, please visit mcglinchey.com. On behalf of the law firm that brings you more, we hope you'll join U.S. next time.

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