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Tip Allocation: A Compliance Study tor Restaurants

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Abstract
Survey research of the commercial food service industry with regard to tips and tip allocation revealed that 50 percent of restaurateurs require that employees report a minimum amount or percentage of sales and over 50 percent which allocate tips report them as employee income. The authors discuss these results and point out other problems.

Keywords
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Tip Allocation: A Compliance Study for Restaurants

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Survey research of the commercial food service industry with regard to tips and tip allocation revealed that 50 percent of restaurateurs require that employees report a minimum amount or percentage of sales and over 50 percent which allocate tips report them as employee income. The authors discuss these results and point out other problems.

As part of the Tax Equity and Fiscal Responsibility Act of 1982, a new reporting concept was introduced into the Internal Revenue Code known as "Tip Allocation Reporting." The intent of the new law was for qualified[1] food and beverage operations to report directly to the IRS certain tip information. Generally, if aggregate tips reported by a qualified operation fell below a certain prescribed level (almost always 8 percent), then the employer was to allocate tips to those employees who failed to report at least the prescribed level.

What has made tip allocation so unique and confusing is that the tip allocation is a reporting device only and has not altered in any fashion the existing law on tip reporting by employees. An employee has always been the person responsible for his or her reporting to the employer of the tips received. As a matter of fact, in 1985 the IRS issued regulations which reinforced this view when it required that employees keep detailed daily records of tips received and reported to employers.[2]

Two recent events have added renewed interest in the accuracy of obtaining correct information using the tip allocation procedures by hospitality firms. First, the IRS recently announced that it was sample auditing hospitality firms which have allocated tips to determine if these firms have complied with tip allocation procedures. Second, as part of the Tax Correction Act of 1987, hospitality firms must now pay FICA taxes on all tips received by their employees.

Given the importance that the tip allocation rules play in the hospitality industry, we wanted to measure how restaurants are complying with the tip allocation rules.

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Cross-Section of Restaurants Studied

A total of 400 questionnaires were mailed to restaurateurs who are members of the National Restaurant Association. Ninety-four (nearly 24 percent) of the surveys were returned. Exhibit 1 reflects general information about the respondents. Owners represented 46.81 percent of the respondents; general managers, 43.62 percent; and others, 9.57 percent, including corporate treasurers and other financial personnel.

Exhibit 1
General Information Regarding Respondents

Position of Respondents		
Owner	44	46.81%
General Manager	41	43.62%
Other	9	9.57%
Total	97	100.00%
Size of Restaurants of Respondents (Annual Sales)		
<$500,000	25	26.60%
$500,000 to 1,000,000	33	35.11
$1,000,000 to 2,000,000	21	22.34
>$2,000,000	14	14.89
No answer	1	1.06
Total	94	100.00%
Mix of Food Sales		
0–49%	1.06%	
50–59%	0	0
60–69%	14	14.89
70–79%	26	27.67
80–89%	29	30.85
90–100%	21	22.34
No response	3	3.19
Total	94	100.00%
Mix of Beverage Sales		
0%	15	15.96%
1–9%	6	6.39
10–19%	21	22.34
20–29%	34	36.17
30–39%	14	14.89
40–49%	0	0.00
> 49%	1	1.06
No response	3	3.19
Total	94	100.00%

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The restaurant properties were segmented by gross sales ranging from less than $500,000 in annual sales to sales in excess of $2 million annually. As shown in Exhibit 1, those restaurants with gross sales between .5 million and 1 million (35.11 percent) represented the largest percentage of respondents. Exhibit 1 also shows over 90 percent of the respondents were associated with independent restaurants, 5 percent with national chains, and 4 percent with regional chains.

Finally, restaurateurs were asked what percentage of total sales were represented by food and beverage. Exhibit 1 shows that the majority of restaurants reported food sales of 80 percent or more of total sales, while the majority of restaurants reported beverage sales between 10 and 30 percent of their total sales.

Frequency and Method of Employee Tip Reporting Varies

Respondents were queried regarding the frequency and method employees used to report their tips. The frequency of reporting ranged from daily to monthly with the greatest frequency occurring on a weekly basis as follows:

Daily	29	30.85%
Weekly	38	40.43
Bi-weekly	11	11.70
Semi-weekly	6	6.38
Monthly	6	6.38
Other	4	4.26
Total	94	100.00%

Thus, weekly reporting is most common, while 30.85 percent report on a daily basis. This is an interesting statistic since IRS regulations require that an employee maintain detailed daily records of tips received, though daily reporting is not required. The IRS requires employees to report tips to employers on at least a monthly basis. Responses shown as "other" above included: "They don't report to us–just to the IRS" and "Employees report their own tips. It's totally up to them to declare." No differences in the frequency of reporting were noted based on size of restaurant or mix of sales.

Most employees use IRS Form 4070, Employee's Report of Tips to Employer (70.8 percent), or they use the back of their time cards for reporting tips (24.0 percent). Others (5.2 percent) use in-house forms.

This research also attempted to determine how the tip allocation law impacted the reporting requirement of restaurants regarding the amount of tips reported by employees to employers. Respondents were asked whether a minimum amount or percentage of sales was required to be reported as tips by employees; half of the respondents (n = 47) stated that employees had to report some minimum amount of sales as tip income. Generally, the required percentage, as expected, was 8 percent of sales (38 out of 47); however, other restaurateurs required 9, 10, and 15 percent or a certain amount per hour, such as $5 in one case.

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The 50 percent requiring minimum tip reporting is a rather startling percentage since the IRS has repeatedly stated that tip allocation is an information reporting device only and that employees are to report all tips received, not just a certain percentage. Incidentally, only three firms indicated their employees are required to report 100 percent of their tips and one indicated employees were required to report 100 percent of credit card tips. Respondents of properties which require a minimum tip amount or percentage to be reported by employees were queried how the requirement is enforced. The majority of respondents stated that tips were monitored by the appropriate employee to insure compliance. The actual monitoring was accomplished in a variety of ways by management, including the use of point of sale registers, the use of computers, and manual checking with the use of guest checks. Intimidation is also used to encourage employees to report a minimum amount or percentage of sales as revealed by the following responses:

- paychecks are withheld if employees fail to report required minimum tips
- the computer is used to check the accuracy of the tip reporting and if employees argue they are fired
- employees are told the law requires 8 percent tip reporting
- if employees do not make (and report) 8 percent they are not good (workers) and are fired

Finally, in one case the employer reported employees reporting the most tips are rewarded, but did not specify the reward.

In a related question, respondents whose restaurants require a minimum of 8 percent to be reported were asked if their employees reported in excess of the 8 percent; 41 percent stated that the employees did not report tips in excess of that amount. This rather large segment appears to indicate that many restaurant employees are not complying with tip reporting requirements that all tips are to be reported as income, not merely tips equal to a fixed percentage of sales.

The percent of each restaurant by gross sales which requires a minimum of 8 percent of sales classification to be reported by tipped employees is as follows:

<$500,000	40.0%
$500,000–1,000,000	60.6%
$1,000,000–2,000,000	38.1%
>$2,000,000	64.2%

Thus, as can be seen, a large percentage of small and large restaurants alike are in violation of the law requiring employees to report a minimum amount or percentage of sales as tips.

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Tip Allocation Defined

The general rule is that qualified hospitality firms must allocate tips to tipped employees only if the aggregate tips reported to the employer during any payroll period (almost all employers select the calendar year as their payroll period) are less than 8 percent of the employer's qualified gross receipts[3] for that period. Generally, the amount allocated is the difference between the total tips reported by employees and 8 percent of the gross receipts in the aggregate. Those employees who report 8 percent or more are excluded from tip allocation and in effect help lower the amount of allocation to those employees who report less than the 8 percent figure.

Thus, no tip allocation is necessary if total reported tips of all tipped employees exceed 8 percent of qualified sales. This does not mean that every employee must report tips of 8 percent (or more) of the share of gross receipts. Tip allocation can be avoided entirely if some employees report tips less then 8 percent of their gross receipts as long as a sufficient number of employees report tips greater than 8 percent to make total tips reported 8 percent or more of qualified sales.

When an employer must allocate tips, the IRS requires the employer to report allocated tips on the employee's W-2 form in box 6. This is an information reporting line and in no way affects the amount of tips reported as income by the employee which should be properly reported on the employee's W-2 in box 10, "wages, tips, other compensation."

It has been the policy of the IRS to notify all employees that they owe additional taxes on allocated tips shown on box 6 of the W-2 form unless a detailed record of tips received, as required by IRS regulations discussed previously, is submitted. It may be argued that the IRS is attempting to utilize tip allocation reporting as a collection device for those employees who fail to maintain adequate documentation. However, the amount allocated on box 6 is really based on an aggregate computation for an establishment and thus, in many respects, is an arbitrary number. However, if the employee can produce the required documentation, the IRS will not attempt to assess additional income tax for the allocated tips shown.

Restaurateurs were then asked if they ever allocated tips due to the failure of their employees to declare tips that equal at least 8 percent of qualified gross receipts; 30 restaurants (32.26 percent) have allocated tips in the past, while 63 restaurants (67.74 percent) have never allocated tips. One respondent did not answer the question.

Of those who had allocated tips, respondents were queried as to whether the employee's taxable income was increased by the allocated tip amount. An alarming 17 restaurants (56.67 percent) out of the 30 restaurants who had allocated tips in the past increased taxable income of the employee by the allocated amount, that is, reporting allocated tips in box 10 rather than box 6 of the employee's W-2. This is clearly a major error on the part of the employer, and employee taxable income is being over-reported to the IRS.

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Not only does this incorrectly increase the taxable income of the employees involved, but the employees affected are also subject to sanctions from the IRS. When tip income exceeds $20 per month, 100 percent of the tip income is to be reported by employees to their employers during the year. Any additional tip income not reported to the employers must be reported at the end of the year to the IRS on Form 4137, Computation of Social Security Tax on Unreported Tip Income. Any employee who did not report the tips required to be reported may be charged a penalty equal to 50 percent of the social security tax due on those tips. Thus, employees may erroneously report allocated tips on Form 4137 when allocated tips are incorrectly reported to them on their W-2 as wages, tips, and other income. This may occur since the allocated tips would be in excess of tips reported by the employee, and employees are informed via the W-2 that the allocated tips are income. The end result of extra FICA taxes and penalty could occur because of the error in employers reporting allocated tips and the additional error of employees reporting the allocated tips on Form 4137.

The IRS has been aware of the confusion over this problem of reporting the allocated tips as income. In 1983, the IRS released a news release[4] in which they reminded qualified hospitality firms that tip allocation was for information purposes only and not to be added to employee income. Exhibit 2 shows that of the restaurant properties which allocate tips, misreporting is not necessarily more common to smaller establishments than larger establishments as might be expected.

It has been evident from studying responses from restaurant executives that, after all these years of living with tip allocation, many firms still do not have a firm understanding of the mechanics of how the law operates. Many restaurants are requiring their employees to report a minimum amount of tips in clear violation of the intent of the law. Also, an alarmingly high percentage of restaurants that have allocated tip income have incorrectly increased the taxable income of the employees involved.

The study suggests that many restaurants need to become more aware of the tip allocation rules and their proper application. The risk of improperly reporting income and its effect on the morale of the tipped employees can only be improved with the proper application of the tip allocation rules.

Exhibit 2
Failure of Restaurant Properties to Properly Report Allocated Tips to the IRS

Gross Sales by Restaurant	% of Restaurants Erroneously Reporting
$<$\$500,000	33.3%
\$500,000–1,000,000	80.0
\$1,000,000–2,000,000	50.0
$>$\$2,000,000	40.0

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References

[1] There is a two part test in order to be considered a qualified food and beverage operation for tip allocation purposes. First, tipping must be a customary part of the food and beverage operation. Second, tip allocation rules only apply if the establishment has 10 or more equivalent employees on a "typical business day."

[2] IRS Reg. #31.6053-4 provides in part: "(a)(1) An employee shall maintain sufficient evidence to establish the amount of tip income received by the employee during a taxable year. A daily record maintained by the employee shall constitute sufficient evidence."

"(a)(2)The daily record shall state the employee's name and address, the employer's name, and the establishment's name. The daily record shall show for each work day the amount of cash tips and charge tips received directly from customers or from other employees, and the amount of tips, if any, paid out to other employees through tip sharing, tip pooling, or other arrangements and the names of such employees. The record shall also, show the date that each entry is made. Form 4070A, Employee's Daily Record of Tips, may be used to maintain such daily record. The daily record of tips received by an employee shall be prepared and maintained in such manner that each entry is made on or near the date the tip income is received. A daily record made on or near the date the tip income is received has a high degree of creditability not present with respect to a record prepared subsequent thereto when generally there is a lack of accurate recall. An entry is made 'near the date the tip income is received' if the required information with respect to tips received and paid out by the employee for the day is recorded at a time when the employee has full present knowledge of those receipts and payments."

[3] See IRS Reg. #31-6053-3(J). Qualified gross receipts include cash sales, cash receipts, charges to a hotel room, retail value of complimentary food or beverages served if tipping is customary, and a good faith estimate of food and beverage sales included in a package deal. Qualified receipts do not include carry out sales, sales to which a 10 percent or more sales service charge has been added, tips reported on charge sales if employees do not receive cash from the employer for the amount of such tips, and sales taxes.

[4] IRS news Rel. IR-83-22, February 8, 1983 which provided: "The allocation of tip income required by TEFRA is only for reporting purposes. Bar and restaurant owners should withhold income and social security taxes to the extent tips are reported to them by their employees but not on tips that merely allocated."

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