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REPORTING TIP INCOME

Restaurants and other businesses where employees receive tips must keep a record of tips income in order to report them in the employees' W-2 and withhold required taxes. As a general rule all tips received by employees from customers are subject to withholding. Employees are required to report all tip income received in their tax returns, including (1) tips the employer paid over to the employee which were charged to customers and (2) tips the employee received directly from customers. Keep in mind, however, that not all "extra payments" received from customers are considered tips. For instance, large dining party automatic gratuities, banquet event fees, cruise trip package fees, and bottle service charges are deemed service fees and not tips; thus, the portion of these paid to employees is considered part of wages or salaries.

Employee Reporting Requirements

Employees are required to report to their employers tip income received on a monthly basis. Essentially, employees that receive tip income exceeding \$20 in any given month must complete IRS form 4070 (or a similar statement) and deliver it to his or her employer on or before the 10th day of the next month. Note that tips to be reported in form 4070, or its equivalent, include tips received via credit and debit card payments, tips in cash and even those tips received from other employees. In theory, tips must be reported to the employer even if the employer already has a record of tips collected from customers who pay with credit or debit cards and even checks.

Employer Reporting Requirements

Like in the case of salaries and wages, employers must collect income tax, employee social security tax and employee Medicare tax on tips reported by employees. These taxes may be collected from an employee's wages or from other funds he or she makes available. For instance, if an employee reports that he or she received \$1,000 in cash tips the prior month, then the employer may withhold the 7.65% social security and Medicare from the wages paid to the employee.

Tips on Tips

As an employer, you must ensure that the total tip income reported to you during any pay period is, at a minimum, equal to 8% of your total receipts for that period. The rationale of this rule is that a significant portion of customers of restaurants and other similar businesses pay tips in cash. Thus, to reduce tax evasion, there is a presumption that tips amount to at least 8% of receipts. Note, however, that any upward adjustment to tips is not subject to income and social security and medicare tax withholdings. The adjustment is just for IRS information purposes.

In calculating 8% of total receipts, non-allocable receipts are excluded. For tip calculation purposes, non-allocable receipts are defined as receipts for carry out sales and receipts with a service charge added of 10% or more. Thus, if sales in your restaurant amount to \$1,000,000 a year, excluding carry out sales and those sales to which service charges are automatically applied, then total tips reported to the employer by all employees must amount to at least \$80,000.

If the total tips reported by the employees is less than 8%, you must allocate the difference between the actual tip income reported and 8% of gross receipts. There are three methods for allocating tip income:

- Gross Receipt Method: Allocate, to employees, the difference between the 8% calculation and actual tips reported, based on the proportion of tips that each employee reported.
- Hours Worked Method: Allocate the tips deficit to employees based on the proportion of the hours they worked to total hours worked by all employees.
- Good Faith Agreement: Allocate the tips deficit based on an agreement reached with employees.

The IRS may allow employers to use a 6% tips rate for tip allocation purposes if the employers files an application, the details of which are available in the instructions for IRS form 8027.

Other Reporting Requirements

Reporting requirements for employers with employees that receive tips are, in addition to those herein included, basically the same as for other employers. However, employers who operate large food or beverage establishments must file

Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips to report employee tip income. Employers within the large food or beverage establishment category include those with the following characteristics:

- Food or beverage is provided for consumption on the premises
- Tipping is a customary practice
- More than 10 employees, who work more than 80 hours aggregate, were normally employed on a typical business day during the preceding calendar year.

Feel free to send an e-mail to jpnavarro@nacpr.net or info@zoompayrollsolutions.com for a consultation.

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