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Tip Reporting In Independent Food And Beverage Establishments

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TIP REPORTING IN INDEPENDENT FOOD AND BEVERAGE ESTALISHMENTS

Introduction

Many Americans enjoy going out to eat. According to a recent survey by *LivingSocial.com*, the average American eats 4.8 meals per week in restaurants or 249 total restaurant meals per year, both dine-in and carry-out (Living Social, 2011). Zagat's most recent survey reports an average of 3.1 meals per week eaten out (Zagat, 2012). Projected food and beverage sales estimated by the National Restaurant Association for 2013 are $661 billion, which would comprise 4% of the U.S. gross domestic product. Employees of the food and beverage industry in 2013 will reach 13.1 million people, making up 10% of America's workforce (National Restaurant Association, 2012). At the conclusion of a restaurant meal, the customer pays for the food and services received; in addition, most customers will leave a tip for the server (Bodvarsson, Luksetich, & McDermott, 2003). Zagat's 2013 survey reports an average tip of 19.1% of the price of the meal (Zagat, 2012).

Tips are a substantial source of income for servers in the United States (Lynn & McCall, 2000). Because tips are considered income, they are to be reported as such to the IRS so that taxes can be paid on them. Tipping is a private exchange between a customer and a service provider; therefore, the responsibility to report the correct amount of tip falls upon the employee who was involved in the transaction (Lynn, 2006). Due to the private nature of this exchange, employees have the ability to under-report their tip earnings to avoid paying taxes on the full amount. In 1988, the IRS estimated that fewer than 40% of all tips received were reported, which amounted to an estimated $9-12 billion in unreported income (Robertson, Quinn, & Carr, 2006). Shortcomings obviously exist in the current system that allow for such astronomical amounts of unreported tip income.

Institutional Background

The 2013 edition of the Oxford English Dictionary defines the word "tip" as a verb meaning, "a small present of money given to an inferior, esp. to a servant or employee of another for a service rendered or expected; a gratuity" (OED, 2013) Scholars believe that the exercise of tipping began in the Middle Ages where the aristocratic structure of society enabled the practice to develop. When society is structured in a manner that allows for a division of economic classes, the practice of tipping can flourish. This is true because tipping has always been considered an

economic transaction between the socially superior and the socially inferior. (Dublancia, 2010)

While evidence of tipping can be found in Europe as early as the 1500's, it did not become a prominent practice in the United States until after the Civil War (Surowiecki, 2005). America was built on the hope and promise of social equality, and tipping is not a practice that would be needed if all participating parties were on the same level. After slavery formed a racial divide between classes of individuals and directly challenged the equality concept, the practice of tipping in America became prominent. As capitalism and industrialism spread across the nation, a distinct class of workers emerged who could fall subject to the expectation of tipping.

Businesses began to see the financial benefits that the practice of tipping could offer; by allowing and encouraging customers to give tips to employees, businesses could pay lower wages and decrease their labor costs drastically. A major company that took advantage of this structure of pay was the Pullman Palace Car Company (Dublancia, 2010) See also (Ayres, Vars, & Zakariya, 2005). Pullman's porters eventually responded to their forced dependence on tips for compensation by forming the Brotherhood of Sleeping Car Porters in 1925, the first labor organization led by blacks to receive a charter in the American Federation of Labor (Wikipedia, 2013). As industries and legislation have evolved over the years, tipping in the U.S. has become commonplace, particularly in the hospitality industry where businesses are following the Pullman model of paying low wages and expecting employees to be further compensated by tips from customers.

In the hospitality industry, a tip, otherwise known as a gratuity, is a monetary payment that represents the customer's opinion of or compensation for service received. A tip is typically given in cash or is added to the credit card or debit card transaction; it is usually calculated as a percentage of the total charge for the food and service provided. While the choice to pay a tip is completely voluntary, many cultures hold an expectation that one will always be given (Bodvarsson, Luksetich, & McDermott, 2003). The IRS considers a tip to be taxable compensation rather than a nontaxable gift (IRS Pub. 531, 2013).

Service charges are not the same thing as tips; IRS Publication 531 draws a clear line between the two. A service charge occurs when the employer adds a mandatory percentage charge to the customer's bill, typically for larger parties. When the employer adds this charge to a bill, it is considered a service charge and is not to be included in the tips reported by the employee. Service charges are considered as a part of wages and will be reported as such by the employer (IRS Pub. 531, 2013).

Due to their status as taxable income, tips must be reported by the employee to the employer so that the employer can report them to the IRS (IRS

Pub. 531, 2013). Federal and state income taxes as well as Social Security and Medicare taxes (referred to as FICA taxes, after the Federal Insurance Contributions Act of 1935) are withheld from reported tips and wages, all of which is then reported to the employee on an annual W-2. Employers pay additional FICA taxes on the wages and tips of their employees. The employer reports the total of all tips received by all employees to the IRS on an annual Form 8027. One potential danger can be that the IRS reviews the Form 8027 and decides by using an aggregate estimation method that more tips should have been reported and that therefore more FICA taxes should be assessed. In this scenario, the burden of correcting the issue is often on the restaurant, not the employee, even though the employee is the one who evaded taxes by under-reporting tips.

A Brief History of Tip Taxation and Reporting

Before 1965, employers did not have reporting and withholding responsibilities for tip income earned by their employees. Payroll tax law was amended in 1965 so that employees were to have FICA taxes withheld from tips earned as well as from hourly wages (Robertson, Quinn, & Carr, 2006). At this time employers paid a matching amount of employment tax on wages earned, but were not required to match the FICA tax on tips earned. In 1977, the law was amended to require employers to pay a matching amount of FICA tax on tip income, but only on the amount of tip income required to increase employee wages to the minimum wage per hour (Robertson, Quinn, & Carr, 2006). Employees, however, were required to pay employment and income tax on all tips, even those that resulted in total compensation exceeding minimum wage.

In 1987, the law was changed one more time to remove the minimum wage ceiling from the employer's FICA tax requirements (Robertson, Quinn, & Carr, 2006). After all of these changes, tip income became fully taxable to both the employee who earned it as well as to the employer (for purposes of the Social Security and Medicare taxes). The restaurant industry did not like the extra tax burden resulting from the changes made in 1987. In an effort to alleviate some of that burden, Congress added Internal Revenue Code Section 45b in 1993, which provides a dollar-for-dollar, nonrefundable tax credit for restaurants for the amount of FICA taxes paid on tips above minimum wage (Robertson, Quinn, & Carr, 2006). Beginning in 2007, "minimum wage" is frozen at $5.15 for purposes of computing the credit. So for example, if the wait staff is paid $2.50 per hour and works 10,000 hours, collecting $200,000 of tips in the process, the employer is required pay FICA tax on $225,000 of total compensation. Had the employer paid an hourly wage of $5.15, total wages paid would have been $51,500. The employer cannot claim the credit on the $26,500 tips necessary to increase the employees' actual wages of $25,000 to "minimum" wages of $51,500, but can get a credit for the FICA taxes paid on the remaining ($200,000 - $26,500) or

$173,500 tips. Since this tax credit is nonrefundable, it can only reduce the tax liability to zero; any excess amount is not refundable to the employer (Internal Revenue Service, 2013a).

While the tax credit alleviates some of the tax burden on employers, taxes are still payable by both the employer and the employee on all wages and reported tips. This current state of the law does not give either party much incentive to truthfully report tips received, since that would require paying taxes on them. If some tips are simply not reported, taxation is avoided (actually, evaded) and there is more money remaining in the pocket of the employee, and less tax paid by both the employee and the employer.

In an attempt provide more incentive to the employer to ensure that tips are reported correctly, the Tax Equity and Fiscal Responsibility Act of 1982 added Internal Revenue Code Section 6053(c), which requires employers whose employees did not report tips equaling at least 8% of gross sales to allocate additional tips among employees to bring total tips up to an amount equal to 8% of sales revenue (Robertson, Quinn, & Carr, 2006). The rationale for this requirement is that since tips are usually calculated as a percentage of the sales price, total sales for the year can be used to estimate the total amount of tips that should be reported. By setting this standard, the IRS ensures that at least an 8% tip rate is reported for all food and beverage establishments. If employees do not voluntarily report this amount, the employer must allocate the difference among the employees. While this new rule added an incentive for employers to make sure that tips equal to at least 8% of sales were reported, it also provided a benchmark for the misconception that as long as reported tips equal 8% of sales, the employer will be safe from a tip audit (Robertson, Quinn, & Carr, 2006).

Current (2011/2012) Employee Requirements

The IRS annually produces Publication 531 to assist tipped employees with reporting tip income. The publication states, "All tips you receive are income and are subject to federal income tax. You must include in gross income all tips you receive directly, charge tips paid to you by your employer, and your share of any tips you receive under a tip-splitting or tip-pooling arrangement." The publication breaks the tip reporting process into three steps: 1) Keep a daily tip record, 2) Report tips to the employer, and 3) Report all tips on your income tax return (IRS Pub. 531, 2013).

It is important to keep a daily tip record so that tips earned are reported accurately to the employer and on the tax return. Having an accurate record will also allow the employee to prove their tip income if it were ever to be questioned. The IRS recommends three ways of reporting tip income records, either by recording it in a tip diary, keeping all copies of necessary documents, or electronically through the employer's computer system (IRS Pub. 531, 2013).

Publication 1244 was also created to assist in this process; it includes instructions as well as Form 4070A which is to be used by the employee as a daily record of tip income and Form 4070 which can be used to report monthly tip income to the employer (IRS Pub. 1244, 2005) Employees can request a copy of Publication 1244 from their employer or directly from the IRS. If the employee chooses not to use Form 4070A, they can keep a personal record of the following information: employee name, employer name, business name (if different from employer name), date, cash tips received directly from customers or other employees, tips from credit and debit card charge customers that the employer pays to the employee, value of any noncash tips received, and the amount of tips paid out to other employees and the names of those employees (IRS Pub. 531, 2013).

Tip income must be reported to the employer so that the employer can withhold federal income tax and FICA taxes. Tips that need to be reported to the employer include, cash, check, and debit and credit card tips totaling over $20 a month. If a tip-splitting or tip-pooling system is in place, the employee only reports the amount they receive and retain (IRS Pub. 531, 2013).

Current (2011/2012) Employer Requirements

Internal Revenue Code Section 6053(c) outlines special reporting requirements for 'large' food and beverage establishments. 'Large' food and beverage establishments are defined as those that have more than ten employees on a typical business day, and where tipping is customary. Due to their size, 'large' food and beverage establishments must file a Form 8027 also known as, "Employer's Annual Information Return of Tip Income and Allocated Tips." The form reports gross food and beverage sales receipts, employee-reported tip income, total charge receipts and total charge tips (IRS Form 8027, 2012).

In addition to reporting requirements, the employer also has withholding and tax paying requirements. Employees pay Social Security and Medicare (FICA) taxes and employers pay a matching FICA tax for their employees (Internal Revenue Service, 2013b).

Implications of Underreporting

If employees underreport tip income there can be a number of negative consequences for both the employee and the employer, including audits, additional taxes assessed, or even fines or penalties for understating income. Employees could face a penalty equal to 50% of the FICA tax owed on unreported tips (IRS Pub. 531, 2013).

Employees are responsible for reporting total tip income to the employer so that taxes can be withheld and paid. Sometimes the IRS assesses additional tax from employees who are found to have under-reported tips. While this is the fair approach for handling such a situation, it is not a realistic one. The IRS does not

have the funds or time to audit each individual employee who might underreport tips. The easier way to assess additional taxes is by placing the responsibility for the taxes upon the restaurant rather than the employees. This approach is known as an employer-only audit, where the employer becomes involved with the IRS in an audit, and is often assessed additional taxes, without the IRS auditing the employees or assessing them for any additional taxes (Robertson, Quinn, & Carr, 2006).

Due to the steady inflow of tip income earned by wait-staff, food and beverage establishments are able to reduce their labor costs by paying their staff less than minimum wage per hour. As long as the hourly wage added to the total tips earned averages out to the state-mandated minimum wage per hour, this practice is completely legal. For example, in North Carolina the minimum wage per hour is $7.25, whereas the tipped employee minimum wage per hour is only $2.13 (North Carolina Department of Labor). If employees were to underreport their tips by too much they might not average out to minimum wage per hour, which would make it appear that the restaurant is in violation of labor laws. This is another example of how the restaurant can suffer the consequences of employee dishonesty.

Another major implication that is often overlooked is the matter of Social Security benefits. "If you work as an employee in the United States, you must pay Social Security and Medicare taxes in most cases (Internal Revenue Service, 2013c). Taxes paid to the Social Security Administration contribute to coverage under the social security system. Employers deduct these taxes from each paycheck and pay matching amounts as employment taxes (Internal Revenue Service, 2013b). However, if the employees underreport their tip income then the income is not reported to the Social Security Administration. In the event that the employee retires, becomes disabled or passes away, he or she will receive less social security benefits than he or she is technically entitled to, because lifetime earnings were under-reported to the Social Security Administration. To illustrate this point, Figure 1 shows income reported and social security benefits received at retirement for an individual who was born in 1980 and would retire at 67 (Social Security Administration). As the example shows, a 40% reduction in income reported amounts to a 24% reduction in Social Security benefits received.

Figure 1
Future Social Security Benefits Based on Reported Income

Reported Income	Annual Social Security Benefits Received
$25,000	$13,332
$15,000	$10,128

In the event that employees underreport their tip income, they will have more cash immediately and pay less tax now; however, they are hurting themselves in the long run because any social security benefits they might receive in the future will be much less than they would have been if all income had been properly reported.

Tip Agreement Programs

To avoid employer penalties for underreporting and under-withholding among tipped employees in the food and beverage industry, the IRS established voluntary compliance agreements (Internal Revenue Service, 2013d). The goal was to encourage compliance of tip reporting through educational means instead of the traditional enforcement actions. Currently there are three types of tip agreement programs available to participants of the food and beverage industry: the Tip Rate Determination Agreement (TRDA), the Tip Reporting Alternative Commitment (TRAC), and the Employer-Designed Tip Reporting Alternative Commitment (EmTRAC) (Payroll Practioner's Monthly, 2010).

TRDA. The Tip Rate Determination Agreement (TRDA) has a number of requirements for a participating restaurant in exchange for immunity from prior period audits (Robertson, Quinn, & Carr, 2006). Those requirements are as follows: the employer must work with the IRS to arrive at a tip rate for the employer's various occupations, participating employees must enter into a Tipped Employee Participation Agreement (TEPA) with the employer, the employer must get 75% of the tipped employees to sign TEPAs and to report tips at or above the predetermined rate, and the employer must provide to the IRS the names, social security numbers, job classifications, sales, hours worked and the amount of tips reported for employees who do not report tips at or above the predetermined rate (Payroll Practioner's Monthly, 2010).

TRAC. The Tip Reporting Alternative Commitment (TRAC) agreement does not require tip rates to be established, but does have other requirements for the restaurant in exchange for immunity from an employer-only audit (Robertson, Quinn, & Carr, 2006). Employers are required to provide tipped employees with a statement (at least monthly) of charged tips attributable to each employee, to comply with filing all federal tax returns and paying and depositing all federal taxes, to file Form 8027 where appropriate, and to maintain records of gross receipts and charged sales and tips (IRS Form 8027, 2012). While a TRAC does not require an agreement between the employee and the employer, it does affect all (100 percent) of the employees. TRAC provides that if the employees collectively underreport their tip income, tip examinations may occur, but only for those employees who underreport. A distinguishable requirement of the TRAC agreement is the commitment by the employer to provide quarterly education and reeducation for all directly and indirectly tipped employees and to new hires

covering the statutory requirement to report all tips to the employer. Restaurants that comply with the requirements of this agreement are also immune to prior period examination (Payroll Practioner's Monthly, 2010).

EmTRAC. The Employer-Designed Tip Reporting Alternative Commitment (EmTRAC) agreement was developed in response to employers who expressed an interest in designing their own TRAC programs (Payroll Practioner's Monthly, 2010). This variation of the TRAC program is available to all food and beverage industry employers whose employees receive both cash and charged tips. EmTRAC has three similar requirements as the TRAC program: quarterly and new hire training programs, a legal obligation of employees to report all cash and charge tips to the employer, and the reporting procedure requiring a written statement or electronic statement (at least monthly) reflecting all tips for services attributable to each employee. This agreement becomes effective when the IRS signs the approval letter or agreement. The employer may terminate the agreement at any time, but the IRS can only terminate it if the agency finds that the employer has failed to comply with the agreement's requirements. Figure 2 compares the IRS's TRDA and TRAC programs.

Court Cases

Several landmark cases serve to illustrate the difficulty the IRS has in enforcing the reporting of tips, and they methods they will use to detect under-reporting. The *McQuatters* case of 1973 involved an income tax audit of the employees who worked at the Space Needle Restaurant in Seattle (Robertson, Quinn, & Carr, 2006). The employees reported their tips to the employer who kept records of each employee's wages, tips, and hours worked. Upon examination the IRS discovered that reported tips were very low—less than $1 per hour in many cases. The employees had not maintained any records for their tip income, so the IRS applied an indirect method to estimate the tip income. The IRS first observed that the tip rate for charged sales that included a charged tip was a little over 14%--charged sales made up about 20-25% of the restaurants total receipts. The IRS began the estimation process by reducing the restaurant's annual food and beverage sales by ten percent to account for customers who did not tip and for low-tipping events such as banquets. Sales subject to tipping were divided by the total number of hours worked by wait staff to arrive at average sales per hour. The hours worked by each employee were then multiplied by the average sales per hour to arrive at annual sales subject to tipping for each employee, which was then multiplied by a tip rate of 12 percent to arrive at total estimated tips for the year (McQuatters, 1973).

Figure 2
Comparing TRDA and TRAC Agreements

TRDA	TRAC
Requires the IRS to work with the business to arrive at a tip rate for its various occupations.	Does not require that a tip rate be established but it does require the employer to: • Establish a procedure where a directly tipped employee is provided (no less that monthly) a written statement of charged tips attributed to the employee. • 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 employees.
Requires the employee to enter into a Tipped Employee Participation Agreement (TEPA) with the employer.	Does not require an agreement between the employee and the employer.
Requires the employer to get 75% of the employees to sign TEPAs and report at or above the determined rate.	Affects all (100%) employees.
Provides that if employees fail to report at or above the determined rate, the employer will provide the names of those employees, their SSNs, job classification, sales, hours worked, and amount of tips reported.	Provides that if the employees of a business collectively underreport their tip income, tip examinations may occur but only for those employees that underreport.
Has no specific education requirement.	Includes 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.	Same rule.

(Internal Revenue Service, 2013d)

The employees challenged that 12 percent was too high for a tip rate, and asked the court to reduce it to 7 percent. While the court did reduce the rate to 10 percent, it held that the IRS was justified in using an indirect method to estimate the taxpayer's income because [the employees] had not maintained adequate books and records. This court case is of great importance because the IRS currently uses a variation of this indirect method as the standard for estimating tip income (Robertson, Quinn, & Carr, 2006).

The *Fior D' Italia* case (Fior D'Italia, 2002) illustrates the untenable position restaurant employers find themselves in when it comes to the reporting of tips received by employees. Basically, the employer can be held responsible for the amount of tips reported by the employees, even though the employer cannot and does not observe the cash tips that pass from customer to server. If the IRS decides that the employees are underreporting tips, it can bypass the employees and go straight to the employer to assess additional payroll taxes on the under-reported tips.

Fior D' Italia is an upscale restaurant located in San Francisco (Fior D'Italia, 2002). The restaurant became subject to an employer-only audit after the IRS examined their 1991 and 1992 Forms 8027. A comparison of charge tips to reported tips for those years made it obvious that employees had underreported tips. As they did in the *McQuatters* case, the IRS estimated the tip percentage by dividing charge tips by charge sales; this amounted to 14.49% in 1991 and 14.29% in 1992. The estimated tip percentage was then multiplied by total sales to estimate total tips. The difference between this estimate and the amount that had been reported on the Forms 8027 was treated as the amount of unreported tips. The IRS then assessed the *employer* for their share of FICA taxes on the unreported tips.

Fior D' Italia fought this decision and won at the District Court level. The IRS appealed and lost in the Ninth Circuit Court of Appeals. Due to inconsistencies in how this issue had been decided among several other federal appeals courts, the Supreme Court granted the IRS's appeal, and reversed the lower courts' decisions. The majority held that the IRS was not required to assess additional taxes against each individual employee before moving against the employer. Thus, as a result of this Supreme Court decision, an employer can be assessed additional taxes, interest, and penalties on under-reported tips, even if the employees who are guilty of under-reporting those tips to both the employer and the IRS are not individually investigated or assessed.

Recent Research on Tip Reporting

A 1988 study found that there was a general lack of understanding of tip reporting requirements and inaccurate and possibly illegal procedures being used by hospitality-industry establishments (Schmidgall & Tarras, 1988). Studies

performed in the past twenty-five years have documented the cumbersome nature of tip reporting requirements by employers, widespread misreporting of tips (Anderson & Bodvarsson, 2005) and lack of proper instruction by employers of tipped employees (Schmidgall & Tarras, 1995); other studies have explored the issue of whether tipping should be replaced by mandatory service charges (Brown & Rolle, 1991) (Lynn & Withiam, 2008). A number of studies have discussed court cases and provided advice based on rulings that appeared to limit the IRS's ability to estimate tip income using aggregate methods, or to conduct employer-only audits (Withiam, 1997) (MacNaughton & Veall, 2001). These results have been obsoleted by the more recent Fior D'Italia Supreme Court ruling (Fior D'Italia, 2002).

Focus Group and Interviews

After researching the tax law on this subject, we became curious as to how restaurant managers are currently dealing with the issue of tip reporting. We chose to seek insight from a jury of expert opinion through interviews and a focus group, preparatory to surveying a larger group. The initial focus of inquiry was on the independent restaurants of the Boone, Blowing Rock, and Banner Elk areas in North Carolina. The close proximity of these establishments created an ideal opportunity to interact with the managers and payroll accountants who were employed in the area. The restaurants invited to participate were a mix of casual fare and fine dining with the majority failing in the middle of the range. Restaurants specializing in fast food and self-serve were eliminated because their employees typically do not receive tips.

Due to the limited availability of restaurateurs during the tourism season, it became evident that the initial investigation would have to consist of both group discussion and individual interviews, so that more respondents would be able to participate. We ultimately held discussions with a total of six restaurant managers and/or payroll accountants. Discussion points for the focus group and interviews stemmed from the literature review and initial research, and included questions such as:

- How do you currently handle tip reporting?
- Do you like your current system?
- What percentage of tips would you say goes unreported annually?
- Do you feel that you have a clear understanding of the IRS's reporting requirements?
- Do your employees understand the IRS's reporting requirements?
- What challenges and frustrations do you face when completing the payroll and tip reporting process?

After considering the information collected from the focus group and interview participants, we moved to survey a larger restaurateur population in

order to draw more accurate conclusions regarding the topic of tip reporting and the establishments directly affected.

Survey

The survey formulation process was a collaborative effort with the North Carolina Restaurant and Lodging Association. The questions came from prior research, focus group discussions, and various topics brought up by the individuals who were interviewed. The purpose of the survey was to determine the level of understanding among both employers and employees regarding IRS requirements for tip reporting, and to learn more about the way in which both parties comply with these requirements. What systems do restaurants use? What IRS publications or forms are used? How onerous is the record-keeping burden? The survey consisted of thirteen multiple-choice questions and three open-ended questions, and was administered using an online survey generator called Survey Monkey. (See Appendix A.)

An invitation to complete the survey was e-mailed to an estimated 200 restaurants within North Carolina. Contacts from Boone Independent Restaurants and Asheville Independent Restaurants, as well as various Chambers of Commerce and Tourism Development authorities across North Carolina were utilized, and the North Carolina Restaurant and Lodging Association e-mailed the survey invitation a total of three times to their independent members in Asheville, Boone, Blowing Rock, Charlotte, Raleigh, and Wilmington. The initial e-mail included an introduction to the researchers and an explanation of the purpose of the research. At least two follow-up phone calls and/or e-mails were made after the initial invitation. Assurances of anonymity and confidentiality were given with each communication. Twenty-two responses were received, from a variety of locations within the state.

Survey Results

Survey results show that 86.4% of employees receive a biweekly paycheck for their hourly wages, and 63.6% of employees receive their credit card tips nightly. Employers estimate that the average credit card sales for a given night are 86% of total receipts, and 79% of charged sales include the tip in the charge. Employers estimate that an average of 22% of all tips goes unreported annually. Only 4.5% of employers stated that the IRS has assessed additional FICA taxes after they filed their annual Form 8027, while 13.6% of employers have been under an employer-only audit by the IRS. Surprisingly, 40.9% of the employers are not aware of the nonrefundable tax credit that is available to restaurants for the amount of FICA taxes paid on tips that result in the employees' average hourly wages exceeding minimum wage. Furthermore, 54.5% of employers have never heard of any of the IRS tip-reporting programs that are

available to them. About one-half of employers state that it requires two or more systems to complete the payroll and tip reporting process, and 59.1% of employers feel that it takes an average of one to three hours a month to track tip reporting. When asked if they understand the IRS's requirements on tip reporting, 63.6% respond that they "completely understand," leaving 36.4% that answered, "not a clue, learning, or somewhat understand." When the employers are asked if their wait staff understands IRS requirements, they estimate that 54.5% "somewhat understand." Fifty-four percent of employers use a Form 8027 to report their earnings and tips to the IRS, while 31.8% use a self-prepared daily tip diary. Over half of the employers (63.6%) feel the need to utilize an in-house spreadsheet in order to complete the payroll and tip-reporting process; 45.5% of employers utilize an outside payroll service, and 40.9% use pre-packaged payroll software.

Interpretation of the Results and Implications to the Industry

Focus group, interview, and survey participants all remarked about the effect that credit and debit cards are having upon the industry. The level of card use has greatly increased in the last several years, and as it continues to increase the opportunities for underreporting tip income are decreasing. When customers pay (and tip) by card an audit trail is automatically formed with the charge amount for both the meal and the tip given. Because there is no cash involved, the employees have no way to hide or misreport their earnings, and the employer has a record of tips received by each employee. This may partially explain why restaurant managers estimate that approximately 22% of tips go unreported, while the IRS's estimate from 1988 was approximately 40%.

On a related note, participants discussed the role of the point-of-sale system in aiding with tip reporting. While a point-of-sale system has the primary objective of serving as a means of communication between the servers and the kitchen, it also provides some other benefits. Point-of-sale systems can provide sales slips for the servers and customers and newer systems can also serve as time clocks so that the employees can clock in and out each workday through the system. Some of the point-of-sale systems that offer the time clock feature also require the employees to report their claimed tip income for the day before they can clock out. A system like that would greatly reduce the record-keeping burden that is placed on restaurant management, because it keeps all the necessary documentation electronically.

Survey results for questions regarding the IRS nonrefundable tax credit for FICA taxes and the IRS tip agreement programs showed an appalling lack of knowledge regarding IRS provisions designed to help restaurants. Over forty percent of restaurant managers responding to the survey are not even aware of the tax credit for FICA taxes and over fifty percent have never heard of any of the

IRS's tip reporting programs. Most employers feel that they have a good understanding of the IRS's tip reporting requirements; however, they feel that their employees are lacking in this area. Many restaurateurs express a belief that if employees were more educated about payroll taxes, they would be more willing to adhere to tip reporting requirements. The IRS clearly needs to find a way to more effectively communicate with the food and beverage establishments that struggle with tip reporting, and to provide better resources for educating tipped employees.

Most restaurant managers expressed frustration with the systems they use to complete the payroll and tip reporting process; the employers felt that it took at least two if not three systems to adequately document all payroll and tip-related data. There does not seem to be a single system that effectively addresses the many needs of employers of tipped employees. If such a system does exist, it needs to be more effectively marketed to the small and medium-sized independent restaurant!

Limitations

While the survey was widely distributed, only twenty-two restaurants responded. A potential explanation for the low response rate would be the timing; the survey was sent out on March 13, a little over a month before individual taxes are due (and right at the time that corporate tax returns are due). Taxes can be a very sensitive subject for both individuals and businesses, and tax season brings those fears and frustrations to primacy. In follow-up conversations, many restaurant managers expressed concerns regarding confidentiality and the true purpose of the survey, despite multiple assurances that the survey was completely anonymous and for research purposes only. Because all responses came from within North Carolina, there may be questions as to whether the results are generalizable to the rest of the country. Since the survey explores issues related only to *federal* income and employment taxes, the authors do not believe that there would be any systematic differences in how North Carolina restaurateurs would answer versus those from any other state. The conclusions are limited, however, to small and medium-size independent establishments.

Conclusions

While tax evasion through the underreporting of tips is declining due to an increase in credit and debit card transactions and the use of more sophisticated point-of-sale computer systems, it is still an issue for the IRS. It is essential for there to be better communication between the IRS and food and beverage establishments on this topic. Restaurant managers are often not aware of the resources available to them. Perhaps the state associations could play a larger role in educating food and beverage establishments regarding tip reporting.

Restaurant managers also seem to bear an unfair tax burden when employees underreport tip income. In addition to insuring ongoing education of tipped employees and vigilant record-keeping, managers should have a contingency plan for the possibility of being audited and assessed additional employment taxes, especially if they have reason to suspect that employees are significantly underreporting tips.

This study is preliminary at best, and leaves many unanswered questions. For example, who is generally responsible for educating employees regarding tip reporting requirements and the potential consequences of underreporting tips? Are there commercial software packages designed specifically for food and beverage establishments that can streamline payroll and tip reporting procedures? Are there procedures and practices in use by larger "chain" restaurants that could be adapted by smaller independent establishments? What constitutes "best practice" in the area of tip reporting? These and other questions could form the basis of a much larger study. Another angle from which to study this topic would be from the standpoint of the customer: does the average restaurant patron understand the tax issues surrounding the tip he leaves for the server? How can more customers be encouraged to include the tip as part of the credit/debit card transaction?

APPENDIX A

Survey Instrument

***1. How often do your employees receive the tips they make from credit card charges?**

- ◯ Nightly
- ◯ Weekly
- ◯ Biweekly
- ◯ Monthly
- ◯ Other (please specify)

***2. How often do your employee receive a paycheck?**

- ◯ Weekly
- ◯ Biweekly
- ◯ Monthly
- ◯ Other (please specify)

***3. How many of the following do you utlize in order to complete payroll and report tips? Please check all that apply**

- ☐ Outside payroll service
- ☐ Prepackaged payroll software (e.g. Quick Books)
- ☐ In-house spreadsheet
- ☐ Other (please specify)

***4. How difficult is it to successfully comply with the IRS requirements for tip reporting?**

- ◯ Only requires the use of one system
- ◯ Requires a second system of record keeping
- ◯ Requires three or more systems of record keeping

***5. How time consuming is it to sucessfully comply with the IRS requirements- approximately how many hours would you estimate are spent tracking tips?**

- ◯ 1-3 hours/month
- ◯ 4-6 hours/month
- ◯ 7-10 hours/month
- ◯ more than 10 hours per month

***6. IRS requirements**

	Not a Clue	Learning	Somewhat Understand	Completely Understand
Do you understand the IRS's requirements on tip reporting?	◯	◯	◯	◯
Does your wait staff understand the IRS's requirements for tip reporting?	◯	◯	◯	◯
Do you understand the IRS forms that are used to report tips?	◯	◯	◯	◯

***7. How do you feel about your current tip reporting system?**

	Live in constant fear of an audit	Not certain of what I am doing	It's complicated, but under control	Piece of cake
How do you feel about your current tip reporting system?	◯	◯	◯	◯

***8. Do you feel like your current system satisfies your needs for payroll and tip reporting correctly?**

	Woefully inadequate	With a lot of extra work it gets the job done	Can get it done with some extra work	Very efficient
Do you feel like your current system satisfies your needs for payroll and tip reporting correctly?	◯	◯	◯	◯

***9. What would you estimate as the percentage of sales is that are paid with a credit card?**

***10. What would you estimate as the percentage of credit sales that include a credit tip?**

***11. What percentage of tips would you estimate goes unreported?**

***12. What forms do you or your staff use to report tips to the IRS? Check all that apply**

- ☐ Form 4070A
- ☐ Pub. 1244
- ☐ Self prepared daily tip diary
- ☐ Form 8027
- ☐ Other (please specify)

***13. Does your establishment partake in any of the following IRS programs?**

- ◯ TRAC
- ◯ emTRAC
- ◯ TRDA
- ◯ Never heard of any of these
- ◯ Other (please specify)

***14. Have you ever been assessed for additional FICA taxes after filing your Form 8027?**

- ◯ YES
- ◯ NO

***15. Has your establishment ever been under an employer-only audit by the IRS?**

- ◯ YES
- ◯ NO

***16. Are you aware of the non-refundable tax credit that is available for FICA taxes paid above minimum wage by your establishment?**

- ◯ YES
- ◯ NO

Other (please specify)

17. Please write any additional comments you may have about the tip reporting process or the IRS's requirements on tip reporting.

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