

**PRESENT LAW AND BACKGROUND RELATING  
TO THE TAX TREATMENT OF TIP INCOME**

Scheduled for a Public Hearing  
Before the  
SUBCOMMITTEE ON OVERSIGHT  
of the  
HOUSE COMMITTEE ON WAYS AND MEANS  
on July 15, 2004

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing for July 15, 2004, on the Internal Revenue Service's ("IRS") enforcement of the tax laws with respect to tip income. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the present law and background relating to the tax treatment of tip income and recent developments.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to the Tax Treatment of Tip Income* (JCX-48-04), July 13, 2004.

## I. BACKGROUND AND PRESENT LAW

### A. Reporting of Tip Income

#### In general

All tips received by an employee are taxable income, not gifts.<sup>2</sup> Employee tip income is also treated as employer-provided wages for purposes of the Federal Insurance Contributions Act (“FICA”). Customers may tip service providers in a variety of ways, such as direct cash payments, additions to credit card receipts, or through non-cash items (such as tickets to sporting events). In addition, the amount tipped may vary significantly from customer to customer. These variations can present significant challenges to service providers and their employers in keeping appropriate records and in complying with their tax obligations as well as to the IRS in enforcing the tax laws. Special statutory rules and administrative measures described below have been developed to improve compliance with these tax obligations.

#### Statutory reporting requirements

The Code requires employees who receive tips in a calendar month to provide a written report of such tips to their employer no later than the 10th day of the following month.<sup>3</sup> Special rules apply to large food or beverage establishments (where tipping is customary and which normally employed more than 10 employees on a typical business day in the preceding calendar year).<sup>4</sup> These establishments must allocate<sup>5</sup> among employees the excess of eight percent<sup>6</sup> of gross receipts over the aggregate amount reported as tips by employees during the payroll period. These establishments must also report annually to the IRS: (1) the gross receipts of the establishment; (2) the total charge receipts; (3) the total tips shown on charge receipts; and (4) the total tips reported to the employer.<sup>7</sup> The employer must also provide each employee with an annual statement that includes the name and address of the employer, the name of the employee, and the amount of tips allocated to the employee.<sup>8</sup>

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<sup>2</sup> *Roberts v. Commissioner of Internal Revenue*, 176 F.2d 221 (9<sup>th</sup> Cir. 1949); *Olk v. United States of America*, 536 F.2d 876 (9<sup>th</sup> Cir. 1976).

<sup>3</sup> Sec. 6053(a).

<sup>4</sup> Sec. 6053(c).

<sup>5</sup> The allocation must be made on the basis of a good faith agreement by the employer and the employees, or under regulations prescribed by the Secretary. Sec. 6053(c)(3).

<sup>6</sup> This percentage may be reduced to as low as two percent with the approval of the IRS.

<sup>7</sup> Sec. 6053(c)(1).

<sup>8</sup> Sec. 6053(c)(2).

## **Tip agreements**

In 1993, the IRS introduced its Tip Rate Determination/Education Program (“TRD/EP”), designed to enhance tax compliance among tipped employees through taxpayer education and voluntary advance agreements instead of traditional audit techniques.<sup>9</sup> The TRD/EP currently offers employers the opportunity of entering into one of two types of agreements, the Tip Rate Determination Agreement (“TRDA”) and the Tip Reporting Alternative Commitment (“TRAC”).

The TRDA requires an employee to enter into a Tipped Employee Participation Agreement (“TEPA”) with the employer. The TRDA requires the IRS to work with the establishment to arrive at a tip rate for the various restaurant occupations. The TRDA requires that at least 75 percent of the employer’s employees sign TEPAs and report tips received at or above the rate determined to be appropriate for that occupation. The TRDA provides that if employees fail to report tips received at or above that determined rate, the employer will provide to the IRS the names of those employees, their social security numbers, job classification, sales, hours worked, and amount of tips reported.

The TRAC does not require the employer to establish tip rates, and employee participation agreements are not required. In this program, the employer agrees to institute and maintain a quarterly education program for directly and indirectly tipped employees. The employer also agrees to establish formal tip reporting procedures. Employers assume responsibility for having their employees report tips, and the IRS agrees not to assess the business employment taxes on unreported tips unless the employees are audited first. This method is available for food and beverage employees only. The IRS may not threaten to audit any taxpayer in an attempt to coerce the taxpayer into entering into a TRAC agreement.<sup>10</sup>

In 2000, the IRS introduced a modified variation of the TRAC, the Employer-Designed Tip Reporting Alternative Commitment (“EmTRAC”), available only to employers in the food and beverage industry that have employees who receive both cash and charged tips. EmTRAC retains many of the provisions contained in the TRAC agreement. The employer must establish an educational program to train employees that the law requires them to report all their cash and charged tips to their employer. The educational program must be furnished to newly hired employees and quarterly for existing employees. The EmTRAC program provides an employer with significant latitude in designing its educational program and tip reporting procedures.

Participation in either the TRDA or the TRAC assures the employer that any prior tax period will not be examined as long as participants comply with the requirements under the agreement.

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<sup>9</sup> *Internal Revenue Service*, Notice 2001-1, 2001-1 C.B. 261.

<sup>10</sup> Sec. 3414 of the IRS Restructuring and Reform Act of 1998 (July 22, 1998), Pub. L. No. 105-206.

## **Recent Supreme Court case**

On June 17, 2002, the Supreme Court, in *United States v. Fior D'Italia, Inc.*,<sup>11</sup> held that the IRS may determine (on an aggregate basis) and assess against the employer, the FICA tax on tips that the employees did not report to the employer. The IRS estimated the unreported tips of the restaurant's employees for FICA tax purposes by calculating an average tip percentage from credit card receipts and applying that percentage to the restaurant's total sales. The restaurant argued that the IRS was not authorized to use this method of aggregate estimating; instead, the restaurant argued that the IRS was required to develop individual estimates for each employee's tip income to calculate the total FICA liability of the employer. The Court held, however, that the IRS was clearly authorized to estimate FICA tax liability, and found that the restaurant failed to show that the method used by the IRS to estimate such liability was unreasonable. The Court affirmed that the IRS could use the aggregate estimation method to determine tip income by aggregating all the tips that the restaurant's customers paid its employees.

### **B. Credit for Employer Portion of FICA Taxes on Tips**

Present law provides a business tax credit equal to an employer's FICA tax obligation (7.65 percent) attributable to certain tips treated as paid by the employer for FICA tax purposes (regardless of whether the tips are reported).<sup>12</sup> The credit is available only with respect to tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption if the tipping of employees receiving such tips is customary. In addition, the credit is available only with respect to the extent such tips exceed the amount of tips that are used by the employer to meet the minimum wage requirements for the employee under the Fair Labor Standards Act. No deduction is allowed for any amount taken into account in determining the credit.

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<sup>11</sup> 536 U.S. 238 (2002).

<sup>12</sup> Sec. 45B.

## II. LEGISLATIVE PROPOSALS

### A. Description of H.R. 2034 (Mr. Herger)

H.R. 2034<sup>13</sup> prohibits the Secretary of the Treasury from issuing a notice and demand to an employer for FICA taxes with respect to tips received by an employee until the Secretary has determined the amount of tips received by the employee. The legislation has the effect of overturning the Supreme Court decision in *United States v. Fior D'Italia, Inc.*

### B. Description of H.R. 2133 (Mrs. Johnson)

H.R. 2133<sup>14</sup> extends to employers of cosmetologists the credit for a portion of FICA taxes paid on tips and requires the education of cosmetologists to better comply with the tax code. The bill expands the present-law business tax credit with respect to certain employer FICA taxes paid with respect to tips.<sup>15</sup> The bill also expands the scope of the present-law information reporting requirements<sup>16</sup> to require persons receiving rent for space in a cosmetology facility to provide annual information reports to the cosmetologists who rent the space. The bill requires everyone (such as an employer) who provides information reports to a cosmetologist also to provide to the cosmetologist a publication designated by the Secretary of Treasury that describes the tax and tip reporting obligations of employees and the tax obligations of independent contractors or proprietorships.

### C. Description of H.R. 118 (Mr. Hefley)

H.R. 118<sup>17</sup> states that the Internal Revenue Code must be applied without regard to *United States v. Fior D'Italia, Inc.*

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<sup>13</sup> H.R. 2034 was introduced on May 8, 2003, by Mr. Herger (for himself and Mr. Tanner). The bill is effective on the date of enactment.

<sup>14</sup> H.R. 2133 was introduced on May 15, 2003, by Mrs. Johnson (for herself, Mr. Hayworth, Mr. Lewis (of Kentucky), Mr. Ramstad and others). The bill is effective for calendar years after 2003.

<sup>15</sup> Sec. 45B.

<sup>16</sup> Present law requires reporting with respect to both employees and independent contractors.

<sup>17</sup> H.R. 118 was introduced on January 7, 2003, by Mr. Hefley. The bill is effective on the date of enactment.