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Mike D'Avolio • Sep. 02, 2019



Employers and employees in the service industries that involve tipping need to comply with a unique set of tax rules. Like wages, you must pay income tax, Social Security tax and Medicare tax on tip income. Tax professionals can share the following guide with clients and prospects to educate and encourage them to stay compliant with the rules.

In general, **tips** are discretionary payments made by customers to employees and can

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Reporting tip income

Employees must report all **cash tips received** to the employer, except total tips under \$20 for a given month. Employees need to report tips to the employer by the 10th of the month after the month the tips are received. **Noncash tips** received from customers are not reported to the employer.

All cash and noncash tips are required to be included in the employee's gross income and are subject to tax. Both direct tips and indirect tips (e.g. bussers and cooks) must be reported to the employer, but you can reduce the number of reportable tips you share with other employees. For example, if you receive a \$150 tip and give the bartender \$25, you would only report \$125.

Employer requirements:

- Retain employee tip reports
- Withhold income taxes and the employee's share of FICA taxes
- Pay employer's share of FICA taxes
- File Form 941, Employer's Quarterly Federal Tax Return along with federal deposits
- Include tip income on Form W-2, Box 1 (Wages, tips & other compensation), Box 5 (Medicare wages and tips) and Box 7 (Social Security tips)

Reporting service charges

Service charges that are distributed to an employee by an employer are treated the same as **regular wages**. Service charges are:

- Not included in the employee's daily tip record
- Included on Form W-2, Boxes 1, 3 and 5

- Subject to FICA taxes and income tax withholding

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If the employer allocates tips:

- They are shown separately on Form W-2, Box 8 (Allocated tips)
- They are not included in Boxes, 1, 5 or 7 (i.e. income tax and FICA is not withheld since the employee didn't report the amount to the employer)
- The employee includes the allocated tips in income and files Form 4137, Social Security and Medicare Tax on Unreported Tip income

Large food or beverage establishments

An employer who operates a large food or beverage establishment must file Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips. The report includes receipts from food and beverages, tips reported by employees and allocated tips.

An establishment is considered a large food or beverage establishment if all of the following requirements are met:

- The operation is located in the 50 states or D.C.
- Food or beverages are provided for consumption on the premises, excluding fast food operations
- Tipping employees for food or beverages by customers is customary
- The employer normally employed **more than 10 employees** on a typical business day during the preceding calendar year

Employer's share of Social Security & Medicare taxes on unreported tips

If an employee fails to report their tips to the employer, the employer is not liable for the **employer's share** of Social Security and Medicare taxes (FICA) on the unreported tips until the IRS notifies and demands the taxes. The employer is not

liable to withhold and pay the **employee's share** of Social Security and Medicare

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Wrap-up

As discussed, the rules surrounding the proper reporting of tip income offer a few twists to reporting typical wages. The bottom line is that tip income is taxed just like wages. Be sure your employer and employee clients that work in the service industries remain compliant with these filing requirements.

IRS resources

- [Publication 531](#), Reporting Tip Income
- [Publication 1244](#), Employee's Daily Record of Tips and Report to Employer

Payroll

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