Tipped Employees

THE Reed GROUP

Tipped Employees

All tips you receive are income and are subject to federal income tax. You must include in gross income all tips you receive directly, charged tips paid to you by your employer, and your share of any tips you receive under a tip-splitting or tip-pooling arrangement.

Reporting your tip income correctly is not difficult. You must do three things.
1) Keep a daily tip record.
2) Report tips to your employer.
3) Report all tips on your income tax return.

Keeping a Daily Tip Record

You must keep a daily tip record so you can:
- Report your tips accurately to your employer,
- Report your tips accurately on your tax return, and
- Prove your tip income if your return is ever questioned.

There are two ways to keep a daily tip record. You can either write information about your tips in a tip diary, or keep copies of documents that show your tips, such as restaurant bills and credit or debit card charge slips.

Tip diary. Start your records by writing your name, your employer's name, and the name of the business. Then, each workday, write the date and the following information.
- Cash tips you get directly from customers or from other employees.
- Tips from credit and debit card charge customers that your employer pays you.
- The value of any noncash tips you get, such as tickets, passes, or other items of value.
- The amount of any tips you paid out to other employees through tip pools or tip splitting, or other arrangements, and the names of the employees to whom you paid the tips.

Electronic tip record. You can use an electronic system provided by your employer to record your daily tips. If you do, you must receive and keep a paper copy of this record.

Tips defined. Whether a payment constitutes a tip is generally based on the following factors.
- The payment must be made free from compulsion,
- The customer must have the unrestricted right to determine the amount,
- The payment should not be the subject of negotiation or dictated by employer policy, and
- Generally, the customer has the right to determine who receives the payment.

Service charges. Do not write in your tip diary the amount of any service charge that your employer adds to a customer's bill and then pays to you and treats as wages. This is part of your wages, not a tip.

Example #1: *Good Food Restaurant adds an 18% charge to the bill for parties of 6 or more customers. Jane's bill for food and beverages for her party of 8 includes an amount on the tip line equal to 18% of the charges for food and beverages, and the total includes this amount. Because Jane did not have an unrestricted right to determine the amount on the "tip line," the 18% charge is considered a service charge. She does not include the 18% charge in her tip diary since service charges that are paid are considered wages, not tips.*

Example #2: *Good Food Restaurant also includes sample calculations of tip amounts at the bottom of its bills for food and beverages provided to customers. David's bill includes a blank "tip line," with sample tip calculations of 15%, 18%, and 20% of his charges for food and beverages at the bottom of the bill beneath the signature line. Because David is free to enter any amount on the "tip line" or leave it blank, any amount he includes is considered a tip and should be included in the tip diary.*

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Reporting Tips to Your Employer

Report to your employer only cash, check, and debit and credit card tips you receive.

If your total tips for any one month from any one job are less than $20, do not report the tips for that month to that employer.

If you participate in a tip-splitting or tip-pooling arrangement, report only the tips you receive and retain. Do not report to your employer any portion of the tips you receive that you pass on to other employees. However, you must report tips you receive from other employees.

Do not report the value of any noncash tips, such as tickets or passes, to your employer. You do not pay Social Security, Medicare, additional Medicare, or railroad retirement taxes on these tips.

When to report. Give your report for each month to your employer by the 10th of the next month. If the 10th falls on a Saturday, Sunday, or legal holiday, give your employer the report by the next day that is not a Saturday, Sunday, or legal holiday.

Allocated Tips

If your employer allocated tips to you, they are shown separately on your Form W-2, box 8. They are not included in box 1 with your wages and reported tips. If box 8 is blank, this section does not apply.

Allocated tips are tips that your employer assigned to you in addition to the tips you reported to your employer for the year. Your employer will have done this if:

- You worked in an establishment such as a restaurant, cocktail lounge, or similar business that must allocate tips to employees, and
- The tips you reported to your employer were less than your share of 8% of food and drink sales.

No income, Social Security, Medicare, additional Medicare, or railroad retirement taxes are withheld on allocated tips.

Reporting allocated tips. You must report all tips you received during the year on your tax return, including both cash tips and noncash tips. Any tips you reported to your employer are included in the wages shown on your Form W-2, box 1. Add to the amount in box 1 only the tips you did not report to your employer. This should include any allocated tips shown on your Form(s) W-2, box 8, unless you have adequate records to show that you received less tips in the year than the allocated figures.

Both wages and tips shown on your Form W-2, box 1, and allocated tips from box 8, are reported as income on your tax return.

Form 4137, *Social Security and Medicare Tax on Unreported Tip Income.* Because Social Security, Medicare, and additional Medicare taxes were not withheld from the allocated tips, you must report those taxes as additional tax on your return. Complete Form 4137 to include the allocated tips.

Deduction—Qualified Tips

A deduction of up to $25,000 is available for qualified tips received during the year that are included on statements furnished by an employer or reported on Form 4137. The deduction begins to phase out when modified AGI exceeds $150,000 ($300,000 MFJ).

If self-employed, the deduction is limited to net profit from the business that received the tips and must be included on a Form 1099. Qualified tips do not include amounts received in a specified service trade or business.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 73.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of $5,000.

This brochure contains general information for taxpayers and should not be relied upon as the only source of authority. Taxpayers should seek professional tax advice for more information.

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