

The Tip Allocations Enigma

This is not tax or legal advice. We encourage you to review these opinions with your own tax adviser and adopt suggestions for your establishment if so advised.

This illustration is intended to bring light on the antiquated and woefully unfair tip income reconciliation system the IRS has bequeathed this generation. It's not that the IRS hasn't tried to provide alternate accounting, it's that those alternates are mired in poor explanations bound up in yesterday's tipping world.

Good intentions, for a too fast-moving world, that ends up telling employers, do the best you can while keeping the intent of the rules in focus and achieving a fair and reasonable accounting. That accounting method is the Good-Faith Agreement method.

Here are the Basics

First: Tell All tipped employees the IRS requires them to report all tips earned, \$20 or more/month on the 4070 form or a signed electronic equivalent. At the same time, you cannot make tipped employees' claim, and you cannot claim for them.

Employees are responsible for their tip reports. An employer's estimate or allocation is not an employee's declaration.

In 35 years as a restaurant owner, I watched employees use tip declarations to manage cash flow—buying diapers and making the rent rather than waiting for yet another seemingly ever-increasing tax refund next spring. No one, not even the IRS, knows the individual's big picture tax situation.

The employer will never have the whole picture, either. In my experience, more customers are tipping employees directly through cash apps.

Keep accurate records, explain the reporting responsibility and penalty risks. Then keep the distinction clear: keep records of what you know the employee received, but you cannot make the employee's declaration for them.

To serve as a valid Form 4070 equivalent, the system must provide an option such as "Adjust," "Edit," or "Declare Different Amount." An employer cannot use an electronic POS system to force a rigid, uneditable declaration of credit card tips. Otherwise, the employer is effectively policing the employee's personal tax strategy which is strictly between the employee and the IRS. If you allocate without instruction from the tipped employee at each pay period and withhold payroll taxes from that amount you are likely not adhering to the law.

Under **26 CFR § 31.3402(k)-1(a)(2)** (subtitled "Limitations"), the regulation explicitly states that an employer is required to deduct and withhold tax on tips "only in respect of those tips which are reported by the employee to the employer in a written statement furnished to the employer pursuant to section 6053(a)."

26 U.S.C. § 6053(a) is the specific federal statute requiring employees to report tips of \$20 or more in a calendar month to their employer. This written statement is fulfilled using IRS Form 4070 or an approved electronic equivalent.

Together, these sections establish the following legal boundaries:

- **Strictly Report-Based Withholding:** Employers are only authorized to withhold income, Social Security, and Medicare taxes based on the exact tip amounts the employee formally reports.
- **No Unilateral Adjustments:** Employers cannot legally assume, estimate, or unilaterally add unreported tip income to an employee's pay period that increase tax withholdings.
- **Allocated Tips Are Exempt from Withholding:** If an employer operates a large food and beverage establishment and is required to allocate tips to employees under 26 U.S.C. § 6053(c) to ensure total reported tips equal at least 8% of gross receipts, they still cannot withhold taxes on those allocated tips. Withholding remains strictly limited to the directed amount the employee reported on their 4070 or its signed electronic equivalent.

There is no penalty for not paying your share of FICA taxes on income not claimed in a timely manner by the individual. When the individual pays those taxes through their tax return the IRS will require your share without penalty. The 45B FICA credit for that added amount will be applicable in the tax year it is paid. (Note: currently FUTA or State impositions are not applied on that late claimed income.)

First: The 4070 Form

The required 4070 form, or its electronic equivalent, clearly illustrate tipped employees may deduct tips paid to other employees.

Line 4. $1+2-3 = \text{Net Retained Tips}$

IRS Publication 1244

Instructions

You must keep sufficient proof to show the amount of your tip income for the year. A daily record of your tip income is considered sufficient proof. Keep a daily record for each workday showing the amount of cash and credit card tips received directly from customers or other employees. Also keep a record of the amount of tips, if any, you paid to other employees through tip sharing, tip pooling or other arrangements, and the names of employees to whom you paid tips.

Form 4070 (Rev. August 2005) Department of the Treasury Internal Revenue Service		Employee's Report of Tips to Employer		OMB No. 1545-0074	
Employee's name and address		Social security number			
Employer's name and address (include establishment name, if different)		1 Cash tips received			
		2 Credit and debit card tips received			
		3 Tips paid out			
Month or shorter period in which tips were received from , to		4 Net tips (lines 1 + 2 - 3)			
Signature		Date			

For Paperwork Reduction Act Notice, see the instructions on the back of this form. Cat. No. 41320P Form **4070** (Rev. 8-2005)

1. Why the Gross Receipts Method (GRM) is Unfair

This method first calculates one restaurant-wide amount: 8% of adjusted receipts (or an IRS-approved lower rate), minus all **reported** tips. It then divides any remaining amount among directly tipped employees with shortfalls.

The main problem with the IRS GRM method is it only gives credit for the **reported** portion of tip pool contributions. The unreported portion goes right back to tipped employees to share. This logic goes directly against the instructions tipped employees are trusting all year when filling out a 4070 form. Namely deducting \$ for \$ credit for tip outs before determining retained tips. A tipped employee is led to believe they are getting credit for tipping out and later (usually never) finds out it depends on the recipient's honesty.

Secondly, the GRM method allows one employee's excess reported tips reduce the restaurant-wide shortfall. A practice that is unfair to the employee reporting properly all year. The GFA method does not use that excess to reduce another employee's shortfall, so its total can be higher. Truer but higher.

IRS Hours-Worked Method

Let's agree the hours method is old school and doesn't work. Employees taking home the preponderance of tips on busy shifts get their unclaimed tips distributed to other workers with similar hours on slower shifts. Overall, the most unfair, with all the same bad traits of the GRM method.

Good-Faith Agreement (GFA) Method

This method determines the individual contributors 8% of adjusted receipts (or an IRS-approved lower rate), deducts their **actual** individually reported tips and their **actual** individually tabulated contribution to the tip pool to determine if a shortfall exists. They own their own shortfall. One person's excess does not reduce another person's shortfall. Full individual tax responsibility. Indirectly tipped employees agree to report all tips earned, \$20 or more/month on the 4070 form or a signed electronic equivalent. A reconciliation is done at the end of the year, and any shortfall will be allocated directly to the individual and noted on Box 8 of the W2.

Edge case: If an indirectly tipped employee has a shortfall, but no allocation is required on line 7 of Form 8027. This is where IRS forms and instructions have not kept up with formal tip pooling. My suggestion is to allocate the documented difference, I always did and it honors my GFA principles: everyone owns their own shortfall; one person's excess does not reduce another's. This does not guarantee IRS approval but a GFA does not require it. Consult your tax adviser before making a Box 8 entry in these circumstances.

Page 8 of the Instructions for Form 8027

Line 7c. Good-Faith Agreement

An allocation can be made under a good-faith agreement. This is a written agreement between you and at least two-thirds of the tipped employees of each occupational category (for example, waitstaff, bussers, and maitre d's*) working in the establishment when the agreement is adopted. The agreement must:

1. Provide for an allocation of the difference between total tips reported and 8% (or the lower rate) of gross receipts among tipped employees** that approximates the actual distribution of tip income among the employees***;
2. Be effective the first day of a payroll period that begins after the date the agreement is adopted, but no later than January 1 of the next year;
3. Be adopted when there are tipped employees in each occupational category who would be affected by the agreement; and
4. Allow for revocation by a written agreement adopted by at least two-thirds of the tipped employees in occupational categories affected by the agreement when it is revoked. The revocation is effective only at the beginning of a payroll period.

Keep a copy of the good-faith agreement for your records.

All this to say: At this time, only the Good-Faith Agreement method with a formal Tip Sharing/Pooling Program can legally and satisfactorily provide fairness to Directly Tipped and Indirectly Tipped employees. This program keeps the intent of the rules in focus and aligns with the IRS objective of individual income responsibility.

*The statement on page 6 of the Instructions for Form 8027 Line 4b is illustrative:

“Treat employees, such as maitre d's, who receive tips directly from customers AND indirectly through tip splitting or pooling, as directly tipped employees.” In other words, allocate them.

Maitre D's have hybrid tip incomes sure but that hardly makes them unique. Front House omelet station cooks, live clam shuckers and buffet carving chefs can all have these dual tip incomes. It's the fact that they have NO SALES and receive tips directly and indirectly through tip splitting or pooling, that makes them unique. The glaring problem is employees with ZERO sales cannot fairly be given an equal share of gross receipts, as in the Gross Receipts Method and the HWM.

** not “directly” tipped employees as delineated in the Gross Receipts Method and the HWM.

*** again, not among the “directly tipped” employees as delineated in the GRM and the HWM.

Please see the comparison of both a Good-Faith Agreement Method and IRS Gross Receipts Method in the Archives> EOY> Allocations Examples.