

## Receiving Tips Can Be Taxing

### Article Highlights:

- Tips are taxable and must be included on your tax return
- Tip splitting and cover charges
- Tip reporting to employer
- Employer tip allocation
- Daily log for tip record keeping

If you work in an occupation where tips are part of your total compensation, you need to be aware of several facts relating to your federal income taxes:

- **Tips are taxable** — Tips are subject to federal income, social security, and Medicare taxes. The value of non-cash tips, such as tickets, passes, or other items of value, is also income and subject to taxation.
- **Include tips on your tax return** — You must include in gross income all cash tips received directly from customers, tips added to credit cards, and your share of any tips received under a tip-splitting arrangement with fellow employees.
- **Report tips to your employer** — If you receive \$20 or more in tips in that month, you should report all of your tips to your employer. Your employer is required to withhold federal income, social security, and Medicare taxes. If the tips received are less than \$20 in any month, they need not be reported to the employer. However, these tips are still taxable and must be reported on your tax return, as they are subject to income and social security taxes.
- **Tip-splitting and cover charges** — Tips you give to others under a tip-splitting arrangement are not subject to the reporting requirement, so you should report to your employer only the net tips you receive. Service (cover) charges, which are arbitrarily added by the business establishment, are excluded from the tip reporting requirements. The employer should add each employee's share of service charges to each employee's wages.
- **Employer allocation of tips** — Tip allocation is applicable to "large food and beverage establishments" (i.e., food service businesses where tipping is customary and that have 10 or more employees). These establishments must allocate a portion of their gross receipts as tip income to those employees who "underreport." Underreporting occurs if an employee reports tips that are **less than 8%** of the employee's applicable share of the employer's gross sales. The employer must allocate to those underreported employees the difference between what the employee reported and the 8%. If you are in this situation, your allocation amount will be noted on your W-2 form. These allocated tips will not have been included in the total wages box on your W-2, so they must be accounted for as additional wage income on your return, unless you have adequate records to show that the amount is incorrect. Because social security, Medicare, and Additional Medicare taxes were not withheld from the allocated tips, to the extent these tips are included in your income, you must report those taxes as additional tax on your return. The IRS frequently issues inquiries when the taxpayer's W-2 shows an allocation of tips and a lesser amount is reported on the tax return.

- **Keep a running daily log of tip income** — Tips are a frequently audited item and it is a good practice to keep a daily log of your tips. The IRS provides a log in Publication 1244 that includes an *Employee's Daily Record of Tips* and a *Report to Employer* for recording your tip income.

If you are receiving tips and have any questions about their taxation, please give this office a call.