



WHAT THE IRS AUDIT GUIDE SAYS ABOUT TIPS

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NOTE: This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

Tips

Workers in the salon industry supplement their base compensation with tip income. Independent Contractors (booth renters) will report their service and sales revenue plus their tips, as gross receipts. Employees should be reporting tip to their employers. Sample audits completed in Las Vegas, NV, showed tips as high as 22 percent of gross sales, but average tips are usually 10-15% of the bill.

Salon owners may state that they do not receive tips and thus have a 0 percent tip rate, but this is unlikely. A generation ago it was thought that employees should be tipped because their base wages are low, but salon owners should not be tipped because they receive a percentage of each employee's earnings. In today's market all stylists and service providers are tipped. A customer rarely understands whether their stylist is an employee or booth renter, and tips based on the service provided.

As with the restaurant industry, tips are sometimes overlooked as income. The challenge with this issue is determining a reasonably correct rate. This section discusses determining a tip rate and calculating tips.

Useful information may be found in:

- Publication 531, Reporting Tip Income;
- Publication 1244, Employee's Daily Record of Tips and Report to Employer.

Calculating Unreported Tips

On the initial information document request, tip records should be requested (tip diaries, etc.). If no records are maintained or provided to the examiner, tip rates can still be determined without diaries, by using some of the following information:

- Charge slips
- Interviews
- Industry practice
- Observations.

The easiest way to determine unreported tips is to calculate the tip rate based on a percentage of service revenue. Determine the best source of information, for example copies of charge slips may be used. Select a sample (for example, 1 month) and calculate the average percentage of tips that are added to charge receipts.

The information can be recorded as in the following example:

Service	Price	Tip	Tip%
Hair Cut	\$30	\$5	16.67%
Perm	\$80	\$5	6.25%
Frost	\$40	\$4	10.00%
Total	\$150	\$14	32.92.%

Total Tip percentage divided by Total number of Sample equals Average Tip percentage.

- Total Service Income \$
- Times Average Tip %
- Equals the Tip Income \$

Total Tip percentage is 32.92%. Divided by the total sample equal 10.97 average tip percentage. The average tip percentage can then be applied to total gross receipts to arrive at total service income,

Total Service Income

- From Tax Return is \$ 47,000.00
- Times Average Tip % 10.97%
- Tip Income equal \$ 5,156.00

Corrected gross receipts equal (\$47,000 + \$5,156) or \$52,156.

It may be helpful to review the following court cases that address the tip issue:

- **Bartell v. Commissioner, 48 TCM 461 (1984), T.C. Memo. 1984-34 6**
Hair stylist in Lord and Taylor Store, Fifth Avenue, New York City, reported the same amount of tips every month in 1978. Commissioner estimated tips at 15 percent of gross sales based on a 1978 nationwide survey of tip income received by service industry employees. Tax Court accepted Commissioner's estimate with slight modification.
- **Becerra v. Commissioner, 28 TCM 108 (1969), T.C. Memo. 196 9-22**
Case involved a beautician in San Francisco department store in 1965. Commissioner reconstructed tips based on estimate of 8 percent of gross sales, supported by testimony salon manager and co-worker. Tax Court found this estimate reasonable under the evidence presented at trial.
- **Brancaleone v. Commissioner, 22 TCM 1676 (1963), T.C. Memo. 1963-318**
Beautician in Macy's Department Store kept no record of tips for 1959. Tips received by fellow beauty operator indicate generally whether tips were small or large. Commissioner's method of reconstruction not discussed.
- **Keller v. Commissioner, 48 TCM 332 (1984), T.C. Memo. 1984 -3 14**
Commissioner estimated tip income at 7.5 percent of gross sales based on average of co-workers' reported tips. Taxpayer had no tip record and Commissioner's reconstruction was upheld.
- **Payne v. Commissioner, 23 TCM 670 (1964), T.C. Memo. 1964-119**
Taxpayer, a co-worker of Brancaleone, reported 2 percent of gross sales earned by him as tips for

1960 (pursuant to his daily record). Commissioner asserted that tips were 20 percent rate. Although doubtful of reported tips, the Tax Court found for the taxpayer.

IRC section 61 defines tips as reportable and taxable income. IRC section 6053(a) imposes reporting requirements for tip income. An employee is required to give his or her employer a written report of tips earned for each month by the 10th day of the next month. This report is required for each month that an employee receives tips of \$20 or more while working for that employer.

IRC section 3121(q) pertains to the employer FICA taxes with respect to tips received by its employees. IRC section 3121(q) states that tips are remuneration and are deemed paid by the employer to the employee. If the employee reports the tips to the employer, they are deemed paid when they are reported. Thus, the reporting rules, the deposit rules, and the contribution bases and rates are all applied as of the date the tips are reported by the employee to the employer. Section 3121(q) also states that, if the employee fails to report tips or incorrectly reports them, the tips are deemed paid when the employee received them. This received date governs for all purposes, but it does not govern any provisions under subtitle F that pertain to employer FICA taxes. (Subtitle F sets out the procedure and administration rules, including the reporting requirements and deposit requirements.) For purposes of employer FICA taxes and subtitle F, if the employee does not report the tips, they are deemed paid when the Secretary makes notice and demand to the employer. This is not a notice and demand under section 6303 (a). It is a special section 3121 (q) notice and demand. Thus, the date of the section 3121(q) notice and demand controls the date on which the employer deposits the employer FICA taxes and the Form 941 on which the employer reports the tips. (Because section 3121(q) is located in Subtitle C, the special rule does not apply to the contribution bases and the tax rates; the employer must look to the year in which the tips were received for these figures.)

Rev. Rule 95-7, published in early 1995, deals specifically with section 3121 (q). The revenue ruling contains Q&A's, and would be worthwhile for examiners to look at it for additional guidance.

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