Chapter 5: Special Taxpayers

Taxpayers in the hospitality industry include employers operating restaurants, hotels, banquet halls, clubs, and many other types of organizations. Also included are the employees who work in this industry: the servers, hostesses, bartenders, bussers, and many others who are essential to the operation of the businesses in this category.

The widespread use of tip income as a means of compensation is a factor that is unique to this industry. It is also a form of compensation that has obtained substantial attention from the IRS, which has developed an equally unique set of rules and reporting requirements for tip income. These rules place obligations and penalties on both employees and employers in this industry. It is essential for the tax return preparer to have an understanding of these rules in order to comply with the necessary rules and reporting procedures.

Please note. Corrections for all of the chapters are available at www.TaxSchool.illinois.edu. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.
Other tax rules exist specifically for employers in this industry. The smallwares deduction represents a rather recent change in rules by the IRS that may be helpful to taxpayers in this industry.

**TAXATION OF TIP INCOME**

In addition to the payment of payroll taxes on wages, employers in the hospitality industry are generally liable for the payment of payroll taxes on tips received by employees from customers.

The payment of payroll taxes on tips presents some unusual issues. Although hospitality industry employers are fully aware of the timing and amounts of wages paid to employees, the employer is frequently unaware of the amounts of tip income paid directly from customers to employees. Moreover, employers in the hospitality industry may have special rules for employees regarding how tips are distributed among all employees. Furthermore, tips are frequently received by employees in the form of cash. IRS rules address the reporting of tips and the associated payroll tax liability.

**What Is a Tip?**

IRS guidance makes a distinction between the following types of payments to employees.

- Amounts constituting a “tip,” which may or may not be subject to payroll taxes
- Amounts that are a “service charge,” which, if subsequently paid to the employee, are always treated as wage income and always subject to payroll taxes

The employer’s characterization of the payment is not determinative.

A tip may be paid by the customer either directly to the employee or to the employer for subsequent payment to the employee. Tip income has the following fundamental characteristics.

- It is presented by the customer free of compulsion.
- The customer must have the unrestricted right to determine the amount paid.
- The amount paid is not determined by negotiation with the employer or dictated by employer policy.
- The customer has the right to determine who receives the payment.

The absence of any one of the preceding factors creates serious doubt as to whether the amount received by the employee is a tip and is indicative that the amount is instead a service charge that the customer pays for use of the employer’s facilities or for other purposes. However, all of the surrounding facts and circumstances must be considered.

The IRS has stated that when hotel customers are required to pay an additional charge of 10% to 15% of their total bill and this additional charge is distributed to the servers and other employees in accordance with a labor union agreement, the amount so distributed constitutes a service charge. It is treated as wage compensation for income tax and payroll tax withholding purposes.

Note. Service charges are income to the employer and are part of the employer’s gross income. Service charges that the employer distributes to employees constitute wage income to those employees. This wage income is deductible by the employer.

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4. Ibid.
Example 1. Norman and Brenda have their wedding reception at Rockport Banquet Hall. After the reception, Norman and Brenda pay their final bill, which includes a 15% gratuity charge that is added to the total amount in accordance with the banquet hall’s policy. After payment by the customer, the banquet hall’s management pays the gratuity amount to its servers, bartenders, and bussers, indicating to these employees that the amount is a tip. However, the 15% gratuity is not a tip for payroll tax purposes but is instead considered to be a service charge. Norman and Brenda did not have the right to determine the amount paid or to determine which employees received specific amounts. Instead, the amount was charged in accordance with Rockport Banquet Hall’s policy. The fact that the banquet hall calls the payment a “tip” when it distributes the amount to employees is not determinative of the character of these payments. Subsequent distribution of that amount to employees by the banquet hall constitutes a wage payment to each employee-recipient. These wage payments are subject to payroll taxes just like any other wage payment.

Example 2. Simon has lunch at the Freetown Café. On his bill, there is a blank line on which Simon can indicate the tip amount. A tip payment is not mandatory, but there are sample calculations for a 15%, 18%, and 20% tip from which Simon can choose. Simon chooses the 15% amount as the tip for the server. The amount Simon pays constitutes a tip. Simon chose to leave a tip free of compulsion. He had an unrestricted right to determine the amount paid and could have left any amount as a tip. Simon had the ability to direct the payment of the amount to his server. The amount of the tip was neither determined by negotiation with the café nor dictated by the café’s policies.

Application of Income and Payroll Taxes

IRC §3121(a) indicates that “wages” for payroll tax purposes includes all remuneration from employment. Generally, cash tips are included in the definition of wages from employment and are therefore subject to payroll taxes. However, the following amounts are not included as wages for payroll tax purposes.

- Noncash tips
- Cash tips totaling less than $20 received in any calendar month in the course of employment with an employer

If an employee works for several different employers, the $20 monthly cash tip exemption applies separately to each employer. For tips totaling over $20 for the month received in the course of employment with an employer, the entire amount of the tip is subject to payroll taxes without subtracting the $20 tip exemption amount. The $20 tip exemption amount only applies if the total amount of tip income for the month from a particular employer is under $20.

Although the preceding exceptions serve to exempt some tips from payroll taxes, all tip amounts (cash and noncash) are subject to income tax.

Example 3. Graziana works as a server at Gargonzola’s PizzaWorks. For the month of February 2013, she receives a total of $18 in tip income. Although she must still report this amount on her Form 1040 for the 2013 tax year for income tax purposes, the $18 tip amount for February is not subject to payroll taxes.