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THE IRS'S EFFORTS TO IMPROVE REPORTING OF TIP INCOME

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The Treasury Inspector General for Tax Administration (TIGTA) concluded in a 2018 report that the Internal Revenue Service (IRS) is not fully addressing billions of dollars in tip income reporting noncompliance and is generally not enforcing the tip agreements it has in place. The IRS has limited resources and is having great difficulty in keeping up with the size and rapid growth in tipping industries, particularly the food and beverage industry. The IRS relies primarily on voluntary tip reporting agreements with businesses, rather than on employer tip audits, to combat nonreporting of tips. Despite a higher risk of noncompliance where no tip agreement exists, there is little incentive for businesses to enter into tip agreements with the IRS because the risk of a tip examination is very low. Following recommendations in the 2018 TIGTA report, the IRS agreed to focus more of its revenue agent resources on conducting audits instead of revising terms of low-risk tip agreements.

This article provides a historical perspective of the steps taken by the IRS and Congress to increase tip reporting compliance and the IRS's efforts to quantify underreported tip income, an explanation of the current tip reporting rules, and a discussion of the adequacy of the current rules to address tip income reporting noncompliance.

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INTRODUCTION

Underreporting of tip income has been a major compliance issue for the Internal Revenue Service (IRS) that continues to this day.¹ Tipping creates opportunities for underreporting of income by employees and employment taxes by employers, with the IRS estimating that 10 percent, or \$23 billion of the estimated \$235 billion individual income tax underreporting “Tax Gap”² in 2006 was due to employees’ unreported tip income.³ Unreported tips of \$23 billion account for 52 percent of the estimated \$44 billion in tip income earned by individuals in 2006.⁴ The Treasury Inspector General for Tax Administration (TIGTA)⁵ concluded in a 2018 audit report (the TIGTA Report) that the IRS is not addressing billions of dollars in tip income reporting noncompliance and is generally not enforcing tip agreements with businesses.⁶

The IRS and Congress have attempted to combat failures of employees to report tips in industries in which tipping is customary. In their repeated efforts to tackle this compliance problem, they have better quantified noncompliance, but the IRS has not been effective with enforcement.⁷ Monitoring tipped income poses challenges for both the IRS and employers, because it is common for employees to underreport their tips. While tipping with a credit card creates a record, many customers use cash to tip, leaving no record beyond what the employee discloses to his employer. The IRS has limited resources and is having great difficulty in keeping up with the size and rapid growth in tipping industries, particularly the food

¹ Due to the impact of COVID-19, underreporting of tip income may not be a major compliance issue for the IRS in 2020, with thousands of restaurants and bars temporarily closed by government mandate and others going out of business permanently.

² The individual income tax underreporting “Tax Gap” is the amount of tax liability not reported voluntarily by individual taxpayers who file required returns on time. The most current estimate of the underreported individual income tax gap for years 2011–2013 is \$245 billion. *See IRS releases new tax gap estimates; compliance rates remain substantially unchanged from prior study*, IR-2019-159 (Sept. 26, 2019). *See also* Kim M. Bloomquist, *The Tax Gap: Holding Steady or Missing in Action?* 165 TAX NOTES FED. 593 (Oct. 28, 2019); Natasha Sarin & Lawrence H. Summers, *Shrinking the Tax Gap: Approaches and Revenue Potential*, 165 TAX NOTES FED. 1099 (Nov. 18, 2019).

³ *See* TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, BILLIONS IN TIP-RELATED NONCOMPLIANCE ARE NOT FULLY ADDRESSED AND TIP AGREEMENTS ARE GENERALLY NOT ENFORCED 3-4 (Sept. 28, 2018) [hereinafter TIGTA REPORT]. The \$23 billion in unreported tips in 2006 accounts for roughly one-third of the unreported non-business income of \$68 billion. *See* IRS, TAX GAP “MAP” (2006). https://www.irs.gov/pub/newsroom/tax_gap_map_2006.pdf. The IRS has not released an unreported tip income estimate for tax years 2007–2019.

⁴ TIGTA REPORT, *supra* note 3, at 3–4.

⁵ TIGTA was established under the IRS Restructuring and Reform Act of 1998 to provide independent oversight of IRS activities. It promotes the economy, efficiency, and effectiveness in the administration of the internal revenue laws. *See* Pub. L. No. 105-206, §1103, 112 Stat. 685 (1998).

⁶ TIGTA REPORT, *supra* note 3.

⁷ Due to diminished resources, the IRS has a difficult task to balance enforcement resources between underreported tip income and other major compliance issues. For example, in 2006, business income underreporting of \$122 billion was five times greater than the \$23 billion in unreported tip income. *See Understanding the Tax Gap and Taxpayer Noncompliance: Testimony Before the H. Comm. on Ways and Means*, 116th Cong. 3 (May 9, 2019) (testimony of The Honorable J. Russell George, Treasury Inspector General for Tax Administration). *See also* IRS, *supra* note 3.

and beverage industry. It relies more on voluntary tip reporting compliance by businesses and their employees through tip compliance agreements with the IRS than on employer tip audits. Enforcement is necessary, because failing to report tips is unfair to wage earners and to those tip earners who accurately report and pay taxes on tip income.⁸

This article focuses on tip reporting requirements and the IRS's enforcement efforts. Part I provides a brief history of tipping and a historical perspective of the steps taken by the IRS and Congress to increase reporting compliance and quantify underreported tip income. Part II explains the current tip reporting rules, and Part III examines the adequacy of the rules to address tip noncompliance through a discussion of TIGTA's recommendations on increasing tip reporting. The article concludes by acknowledging that one hundred percent compliance for reporting tips may not be attainable, but compliance can be improved. The IRS is not using its resources effectively and cannot increase tip reporting compliance unless it assigns its trained examiners to higher-risk areas to help generate greater dollar value adjustments.

I. HISTORICAL PERSPECTIVE

The origin of tipping is commonly traced to Tudor England. In the *New York Times* article "Why Tip?", Paul Wachter explains the history of the custom.⁹ By the seventeenth century, guests staying overnight in private homes were expected to give a "vail" or a small amount of money at the end of the visit to compensate the owner's servants. Soon after, customers began tipping in London coffeehouses and other commercial establishments. One such coffeehouse, which was frequented by the English writer Samuel Johnson, had a bowl with the words "To insure Promptitude" printed on it, and "tip" may be an acronym for this phrase. Tipping was imported to the United States by wealthy Americans who had traveled to Europe after the Civil War and was met with resistance because of its association with aristocratic tradition and opposition to American democratic ideals. In 1904, The Anti-Tipping Society of America was formed in Georgia, and, by 1909, Washington became the first of six states to enact an anti-tipping law. The anti-tipping laws, however, were seldom enforced, and were repealed by 1926, because tipping had become an accepted practice.

With tipping established, how to collect tax on tip income became important. For tax purposes, a payment is a tip if made free from compulsion, not subject to negotiation or governed by employer policy, with the customer determining the amount and recipient of the payment.¹⁰ Servers and bartenders receive tips through additions to the bill on a credit card, from "tip boxes" generally placed near the cash register,¹¹ from other employees as shared tips, or directly from the patron as cash tips. Regardless of how tips are paid, they are considered

⁸ JOINT COMM. ON TAX'N, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, at 199–200 (Dec. 31, 1982) [hereinafter JCT TEFRA].

⁹ Paul Wachter, *Why Tip?* N.Y. TIMES, Oct. 9, 2008.

¹⁰ Rev. Rul. 59-252, 1959-2 C.B. 215; Rev. Rul. 2012-18, Q&A 1, 2012-26 I.R.B. 1032.

¹¹ See Chief Couns. Adv. 201816010 (Dec. 4, 2017).

compensation for services taxable to the employee,¹² yet employees do not always report tips paid in cash. The IRS's and Congress's efforts over time to quantify and increase tip reporting compliance are discussed below.

A. *McQuatters Formula*

In the early 1970s, the IRS succeeded in having the Tax Court agree with its audit approach to calculating unreported tip income.¹³ The Tax Court held in *McQuatters v. Commissioner* that the IRS could use an indirect income measurement method, if the method was both logically and factually sufficient, to determine the tip income of employees who did not maintain proper records.¹⁴ This holding was significant, because it allowed the IRS to use an aggregate estimation methodology, known as the “McQuatters Formula,” to reconstruct tip income. The McQuatters Formula incorporates factors, such as the average tip per credit card receipt, sharing of tips among employees, and a “stiff” factor for customers who leave no tips, to arrive at an hourly tipping rate at each establishment.

B. *The IRS's Efforts to Quantify Nonreporting of Tip Income*

From 1977 through 1985, the IRS conducted Tip Income Nonreporting Projects in 18 districts in four IRS regions—a total of 431 projects—to reduce tip income nonreporting.¹⁵ Since the IRS had yet to develop an overall strategy to reduce tip income nonreporting, these initiatives resulted from localized interest and commitment. The projects primarily focused on the food and beverage industry and resulted in additional tax and penalty assessments amounting to almost \$67 million from examination of over 41,000 tax returns.¹⁶ At the time the projects began, the IRS had developed a computerized system that could reconstruct tip income using the McQuatters Formula.¹⁷

In addition to the Tip Income Nonreporting Projects, the IRS contracted with the Survey Research Laboratory (SRL) of the University of Illinois in 1983 to conduct research on tip earnings to better quantify tip income nonreporting.¹⁸ The SRL interviewed members of 12,800 households, who were asked to maintain a diary of meals they ate at restaurants for a two-week period in a quarter. The study concluded with an estimate that, in 1982, U.S. households dined out on 14.8 billion occasions, spending around \$84.8 billion, and left \$6.2 billion in tips. On average,

¹² I.R.C. § 61(a).

¹³ *McQuatters v. Comm'r*, 32 T.C.M. (CCH) 1122 (1973).

¹⁴ *Id.*

¹⁵ U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-86-119, TAX ADMINISTRATION: TIP INCOME REPORTING CAN BE INCREASED 15–16 (1986) [hereinafter GAO REPORT].

¹⁶ *Id.* at 15.

¹⁷ *Id.* at 16.

¹⁸ *Id.* See Robert B. Pearl and Seymour Sudman, A SURVEY APPROACH TO ESTIMATING THE TIPPING PRACTICES OF CONSUMERS: REPORT PREPARED FOR THE INTERNAL REVENUE SERVICE UNDER CONTRACT TIR 81-52, SURVEY RESEARCH LABORATORY, UNIVERSITY OF ILLINOIS (1983); Robert B. Pearl and Kevin F. McCrohan, ESTIMATES OF TIP INCOME IN EATING PLACES, 1982, <https://www.irs.gov/pub/irs-soi/82esttipinep.pdf>.

they tipped at a rate of 14.3 percent of the cost of the meal, which was close to the 15-percent convention considered as a typical gratuity.¹⁹ More recently, in 2014, the IRS received guidance from a report it commissioned on developing estimates of tipping and stiffing rates, tipping income, and the gap between actual and reported tip income at the aggregate level and by sector.²⁰

C. *The Tax Equity and Fiscal Responsibility Act of 1982*

At the congressional hearings on The Tax Equity and Responsibility Act of 1982 (TEFRA),²¹ the IRS presented its best estimate of unreported tips from data furnished by the Bureau of Economic Analysis of the Department of Commerce, its own in-house estimates on tip income, the SRL study, and Social Security Administration information on tips with FICA taxes.²² The most reasonable estimate for 1981 showed that individuals did not report or pay taxes on more than \$8.5 billion in tip income, resulting in an approximated tax loss of \$2.3 billion, i.e., 84 percent of the taxpayers receiving tips did not report their tip income for a meager compliance rate of 16 percent.²³ Illegal income was the only other income with a lower compliance rate of 5 percent.²⁴

Troubled by the low compliance rate, TEFRA added § 6053(c) to the Internal Revenue Code (the Code) to expand tip information reporting requirements for large food or beverage establishments and encourage reporting of tip income to assist the IRS in its examinations of returns filed by tipped employees.²⁵ Congress was concerned that the low compliance rate was unfair to wage earners and others who voluntarily complied with tax laws yet was mindful to not excessively increase the burden to employees and employers with recordkeeping obligations.²⁶ A large food or beverage establishment subject to § 6053(c) is one where tipping is customary, more than ten employees were employed on a typical business day in the preceding tax year, and food is consumed on the premises.²⁷ “Fast food” restaurants that provide food or beverage of a “carryout” nature are not subject to the reporting requirements.²⁸

¹⁹ In *McQuatters*, the IRS initially estimated that credit card customers tipped at a rate of slightly over 14 percent. However, the IRS arrived at an overall average tipping rate of 12 percent. The court reduced the rate by an additional 2 percent, determining tip income to be 10 percent of food and beverage sales. *McQuatters v. Comm’r*, 32 T.C.M. (CCH) 1122 (1973).

²⁰ See Fors Marsh Group, LLC, ESTIMATING CONSUMER TIPPING BEHAVIOR: REVIEW AND RECOMMENDATIONS (Feb. 2014). See also TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, NATIONAL RESEARCH PROGRAM AUDITS OF INDIVIDUALS ARE CLOSELY MONITORED, BUT THE QUALITY OF TESTS FOR UNREPORTED INCOME IS A CONCERN (Sept. 15, 2011).

²¹ Pub. L. No. 97-248, 96 Stat. 324 (1982).

²² GAO REPORT, *supra* note 15, at 19.

²³ GAO REPORT, *supra* note 15, at 8–19. According to the Department of Labor, in 1982 there were 3 million tipped employees, of which 2.3 million (77 percent) were employed by the food and beverage industry, representing the largest population of tipped employees. See *id.* at 2.

²⁴ JCT TEFRA, *supra* note 8, at 199.

²⁵ *Id.* at 199–200.

²⁶ *Id.*

²⁷ I.R.C. § 6053(c)(4).

²⁸ Treas. Reg. § 31.6053-3(j).

TEFRA also required the Secretary of the Treasury to submit before January 1, 1987, a detailed report on the tip reporting system that described tips actually received and those voluntarily reported to the employer, including the tips reported to the IRS on the employee's individual tax return.²⁹ TEFRA additionally enacted penalties for employees' failure to report tips to their employers.³⁰

D. *Post-TEFRA*

The enhanced tip reporting rules added by TEFRA were intended to encourage reporting of tip income and facilitate the IRS's enforcement efforts.³¹ Data generated as a result of the reporting requirements of TEFRA and the experience gained from the Tip Income Nonreporting Projects put the IRS in a better position to formulate an overall approach for addressing noncompliance.³² According to the IRS, TEFRA increased tip income reporting by 108 percent annually between 1982 and 1983, representing an additional \$1 billion in reported tip income for 1983.³³ At the same time, an analysis showed that implementing TEFRA's reporting requirements was not as costly as had been projected by the food and beverage industry.³⁴ As of 1990, using 1984 data, the IRS estimated that restaurant employees were reporting less than 50 percent of their actual tip income, with the 69,000 restaurants in the study underreporting tips by over \$2 billion.³⁵

In 1993, the IRS initiated a Tip Rate Determination/Education Program (TRD/EP) to enhance tax compliance among tipped employees through taxpayer education and voluntary advance agreements.³⁶ In the past, the IRS had examined tipped employees' tax returns and routinely determined that the vast majority were not reporting their tips.³⁷ These examinations resulted in significant assessments against employees and created an enormous financial burden on both employees and their employers for unpaid taxes. The IRS recognized that the examination and assessment route was an inefficient approach to the tip reporting compliance problem and explored new tip compliance initiatives to encourage voluntary compliance and reduce the burden on employees and employers.³⁸

²⁹ Pub. L. No. 97-248, § 314, 96 Stat. 324 (1982).

³⁰ *Id.* § 315; I.R.C. § 6652(b).

³¹ JCT TEFRA, *supra* note 8, at 199–200.

³² GAO REPORT, *supra* note 15, at 3.

³³ *Id.* at 22–26.

³⁴ *Id.* To comply with TEFRA, the food and beverage industry had projected an initial cost of \$6,000 per establishment for 1983. In a survey conducted by the U.S. General Accounting Office of 27,415 food and beverage establishments, at least 21,604 incurred an initial cost to comply with TEFRA, and, of those, 14,664, or about 68 percent, had incurred an initial cost of \$2,000 or less. The most common types of costs incurred to implement TEFRA were overtime, use of consultants, hiring additional employees, or purchasing computer software or a computer. *See* GAO REPORT, *supra* note 15, at 22–24.

³⁵ *IRS Enforcement of the Reporting of Tip Income: Hearing before the Subcommittee on Oversight of the H. Comm. on Ways and Means*, 108th Cong. 67 (2004) (statement of William F. Conlon, Director, Reporting Compliance, IRS, referencing the Tip Income Study, IRS Research Division Publication 1530 (8-90)) [hereinafter CONLON STMT].

³⁶ I.R.S. Notice 2001-1, 2001-2 I.R.B. 261.

³⁷ CONLON STMT, *supra* note 35.

³⁸ *Id.*

Initially, the TRD/EP offered employers in the food and beverage industry two types of agreements to enter into with the IRS—the Tip Rate Determination Agreement (TRDA) and the Tip Reporting Alternative Commitment (TRAC).³⁹ The Gaming Industry Tip Compliance Agreement (GITCA) was offered to the gaming industry in 2003.⁴⁰ The Attributed Tip Income Program (ATIP) was added in 2006 for the food and beverage industry, with participating employers reporting tip income of their employees based on a formula that used a percentage of gross receipts.⁴¹ An employer that voluntarily contracted with the IRS, and complied with the agreement’s terms, was not subject to tip examinations.⁴²

In 1994, tips reported to the IRS totaled \$8.52 billion, and, in 2003, this number grew to just over \$18 billion.⁴³ Despite the increase in reported tip income, the IRS estimated that unreported tip income might still have exceeded \$9 billion annually.⁴⁴ The IRS attributed the significant increase in voluntary tip income reporting to a combination of factors, including its active involvement in the tipping industries through education efforts, the voluntary tip reporting programs, and enforcement activities.⁴⁵ Another important factor was the opinion of the U.S. Supreme Court in *United States v. Fior D’Italia, Inc.*,⁴⁶ which reaffirmed the IRS’s ability to use aggregate estimation methods to calculate an employee’s tip income and assess the employer its share of FICA tax on the tip income without having to audit individual employees.⁴⁷ Many employers voluntarily entered into tip compliance agreements, because the IRS could use indirect tip estimation methods during a tip examination, and the agreements provided them with audit protection if their terms were complied with.⁴⁸

The IRS has limited resources, and the growth in recent years in the food and beverage and gaming industries has posed a challenge to improve compliance in the tipping industries. The food and beverage industry is the second-largest private employer in the United States, employing almost 14.7 million workers with estimated 2017 sales of \$799 billion.⁴⁹ The American Gaming Association reported that 17 of the 24 states with commercial casinos had growth in gross gaming revenues from 2015 to 2016, with record revenues recorded in some states.⁵⁰

³⁹ Rev. Proc. 2006-30, § 2, 2006-31 I.R.B. 110.

⁴⁰ Rev. Proc. 2003-35, 2003-20 I.R.B. 919, superseded by Rev. Proc. 2007-32, 2007-22 I.R.B. 1322.

⁴¹ *Id.* The ATIP program was extended until December 31, 2011, by Rev. Proc. 2009-53, 2009-49 I.R.B. 746. See discussion *infra* text accompanying notes 51–69 for the current tip reporting programs.

⁴² Rev. Proc. 2006-30, § 6, 2006-31 I.R.B. 110.

⁴³ CONLON STMT, *supra* note 35.

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *United States v. Fior D’Italia, Inc.*, 536 U.S. 238 (2002).

⁴⁷ See discussion of *United States v. Fior D’Italia, Inc.* *infra* text accompanying notes 89–95.

⁴⁸ CONLON STMT, *supra* note 35.

⁴⁹ TIGTA REPORT, *supra* note 3, at 3.

⁵⁰ *Id.*

E. *National Tip Reporting Compliance Program*

The IRS relies on voluntary tip reporting compliance by businesses and their employees, instead of on conducting more employer tip audits, to improve reporting of tip income. To help employers and employees meet their tip reporting and payment obligations, the IRS, in 2007, created the National Tip Reporting Compliance Program (NTRCP), whose mission is to implement policies and strategies for tip filing, reporting, and payment.⁵¹

The NTRCP developed model tip agreements to encourage current and ongoing voluntary compliance with the tipping taxpayer community. The program allows a participating employer to voluntarily enter into a tip compliance agreement with the IRS, under which both parties agree to satisfy certain obligations. Full compliance with the agreement by both the employer and employees prevents the IRS from initiating tip audits of either the employer or its employees.⁵² Before the employer can enter into a tip agreement, the IRS reviews a participating employer's level of compliance to ensure that all federal reporting, filing, and payment compliance are current.⁵³ An employer cannot be forced to enroll in a voluntary tip compliance agreement with the IRS, and the IRS specifically prohibits its employees from threatening establishments with audits to drive them to sign up for tip compliance programs.⁵⁴

There are four voluntary tip compliance agreements, including a compliance agreement specifically for the gaming industry.⁵⁵ A tip agreement may require the IRS and the employer to arrive at a minimum tip rate for different employee occupations using the company's historical tip data, or it may require the employer to establish reasonable procedures and employee training programs to ensure accurate tip reporting by all tipped employees.⁵⁶ The four tip agreements are described below:

(1) GITCAs are used for gaming businesses.⁵⁷ The agreement provides a safe harbor from tip-related examinations for participating employers and employees in compliance with the agreement. It is in effect for three years and is renewable for three-year periods upon expiration, with the tip rate subject to review by the IRS.⁵⁸ At least 75 percent of the employees of the business must sign the

⁵¹ The NTRCP is a compliance territory reporting to the Chief Employment Tax Examination in the IRS's Small Business/Self-Employed Division. Prior to the establishment of the NTRCP, the IRS Employment Tax Examination had primary responsibility for tip compliance. *See* I.R.M. 1.1.16.3.3.3.1 (June 1, 2016), 4.23.3.3.1 (July 19, 2013).

⁵² TIGTA REPORT, *supra* note 3, at 1.

⁵³ *Id.* at 1, note 2.

⁵⁴ Pub. L. No. 105-206, § 3414, 112 Stat. 685 (1998).

⁵⁵ TIGTA REPORT, *supra* note 3, at 1–2.

⁵⁶ *Id.* at 1.

⁵⁷ Rev. Proc. 2007-32, 2007-22 I.R.B. 1322. *See* model GITCA *id.* at Exhibit 1. Gaming businesses include casinos, racinos (combined racetrack and casino), card room, and slot parlors. TIGTA REPORT, *supra* note 3, at 1.

⁵⁸ Rev. Proc. 2007-32, § 4, 2007-22 I.R.B. 1322. Effective July 15, 2020, the IRS has discretion not to conduct a full rate review at the time of a GITCA's renewal if the taxpayer is complying with the

agreement and report their tips at the agreed tip rates.⁵⁹ Annually, the employer must report to the IRS the tips allocated to each nonparticipating employee, and the allocated tips must be reported on the nonparticipating employee's form W-2.⁶⁰ In fiscal year 2017, there were 439 GITCAs in place.⁶¹ While this agreement is typically initiated by the IRS, the establishment can also initiate it.

(2) TRDAs are used for non-gaming businesses.⁶² These agreements have no expiration date, but the IRS monitors the participating employer and employees for compliance each year. At least 75 percent of the tipped employees must participate and report tips at the predetermined rate. The employer annually reports tips allocated to nonparticipating employees and reports those allocated tips on the nonparticipating employee's Form W-2.⁶³ In fiscal year 2017, there were 3,039 TRDAs in place.⁶⁴ This agreement is usually initiated by the IRS but can also be initiated by the establishment.

(3) TRAC agreements can be used by non-gaming establishments.⁶⁵ So long as both the employer and employees comply with the requirements under the agreement and all tips are reported accurately, no tip examinations will be initiated of either the employer or the employees during the participation period.⁶⁶ In fiscal year 2017, there were 65,000 TRACs.⁶⁷ These agreements can only be initiated by the employer and do not expire.

(4) The Employer-Designed Tip Reporting Alternative Commitment (emTRAC) agreement is only available to employers in the food and beverage industry. The emTRAC program provides an employer with considerable latitude in designing educational programs for its employees and tip reporting procedures. The employer usually initiates these agreements and must apply in writing for approval.⁶⁸ In fiscal year 2017, there were ten emTRACs in place.⁶⁹

terms of the GITCA. TE/GE-04-0720-0009, Memorandum for all Indian Tribal Governments Employees (July 15, 2020).

⁵⁹ Rev. Proc. 2007-32, 2007-22 I.R.B. 1322.

⁶⁰ *Id.*

⁶¹ TIGTA REPORT, *supra* note 3, at 2.

⁶² Rev. Proc. 2006-30, § 2, 2006-31 I.R.B. 110. Non-gaming businesses include food and beverage (restaurants, bars, nightclubs), personal services (salons, manicurists, estheticians, barbers, spas), hospitality (hotels, resorts), transportation (taxis, limousines, airport skycaps, car washes), and sports and recreation (golf clubs, cruise ships, tour guides). TIGTA REPORT, *supra* note 3, at 1. *See* model TRDA for the food and beverage industry, <https://www.irs.gov/pub/irs-utl/foodtrda.pdf>.

⁶³ Rev. Proc. 2006-30, § 4, 2006-31 I.R.B. 110.

⁶⁴ TIGTA REPORT, *supra* note 3, at 2.

⁶⁵ *See* model TRAC agreement for the food and beverage industry, <https://www.irs.gov/pub/irs-utl/foodtrac.pdf>.

⁶⁶ Rev. Proc. 2006-30, § 6, 2006-31 I.R.B. 110.

⁶⁷ TIGTA REPORT, *supra* note 3, at 2.

⁶⁸ Rev. Proc. 2006-30, § 2, 2006-31 I.R.B. 110.

⁶⁹ TIGTA REPORT, *supra* note 3, at 2.

II. TIP REPORTING RULES

After the numerous efforts by the IRS and Congress to combat the failure to report tip income, the following rules emerged, which are in effect today.

A. *Are Service Charges Tips?*

Some restaurants charge patrons a fixed percentage as a service charge if, for example, their group has more than a certain number of guests. Suppose that Joe's Restaurant charges a 15-percent service charge for parties of more than six guests. Amy, a patron, pays the bill, and the restaurant distributes the service charge among the servers. This service charge is wages but is not considered to be tips.⁷⁰ The issue is whether Amy could determine the amount she wanted to pay as gratuity to the servers. If she is free to decide the amount of the gratuity and to whom it is paid without being subject to a restaurant's fixed percentage policy, it is considered a tip.⁷¹

B. *What are Employee Responsibilities Regarding Tip Income?*

An employee must give his employer a monthly accounting of all tips received in the course of employment.⁷² Those tips could be from customers using their credit or debit cards, tips shared with other employees, or cash tips received directly from the customer. If the employee does not provide this accounting, the employee is subject to a failure to report penalty equal to 50 percent of the FICA taxes due on those unreported tips.⁷³

No reporting is required if an employee receives cash tips of less than \$20 from each employer in a calendar month.⁷⁴ If an employee meets the \$20 threshold, she provides a tip statement in writing or electronically by the tenth day of the month following the month in which the tips were received.⁷⁵ The statement must include the employee's name, address, and social security number, the statement period, the statement submission date, the dollar amount of tips received, and the employer's name and address.⁷⁶ Form 4070-A (Employee's Daily Record of Tips – for employee's records) and Form 4070 (Employee's Report of Tips to Employer – submitted to the employer) assist employees in preparing the monthly tip

⁷⁰ Rev. Rul. 59-252, 1959-2 C.B. 215; Rev. Rul. 2012-18, Q&A 2, 2012-26 I.R.B. 1032.

⁷¹ I.R.C. § 3121(a). Rev. Rul. 2012-18, 2012-26 I.R.B. 1032, provides factors used to determine whether payments constitute tips. See IRS Pub. No. 531 (Reporting Tip Income) (2019) at 3, in which the IRS advises employees not to report service charges on their monthly tip statements.

⁷² I.R.C. § 6053(a); Rev. Rul. 76-231, 1976-1 C.B. 378.

⁷³ I.R.C. § 6652(b).

⁷⁴ I.R.C. § 3121(a)(12)(B); Treas. Reg. § 31.3401(a)(16)-1. Cash tips include "checks and other monetary media of exchange." Cash tips also include tips received from customers through credit and debit card charges that are distributed to the employee by his employer. Rev. Rul. 2012-18, Q&A 2, 2012-26 I.R.B. 1032.

⁷⁵ I.R.C. § 6053(a); Treas. Reg. § 31.6053-1.

⁷⁶ Treas. Reg. § 31.6053-1.

statements.⁷⁷ Form 4070-A is used to record tips received each day; Form 4070 is a summary of all tips received, the period covered, and the date on which the form was completed. The more detailed Form 4070-A asks the employee to report the amount (a) of tips received directly from patrons and other employees as shared tips, (b) of tips received through his employer but paid by the customer using a credit or debit card, and (c) the employee paid as “tip-outs” to other employees, with the names of employees to whom the tips were paid. In keeping with the spirit of promoting voluntary compliance, Form 4070-A contains the following statement: “This is a voluntary form provided for your convenience.”

C. *Is the Employer Required to Verify the Accuracy of Employees’ Monthly Tip Reports?*

Although the Code does not address whether employers must audit or verify the accuracy of their employees’ monthly reports, several courts have opined on this issue. In *Norfolk Yacht and Country Club v. United States*,⁷⁸ a federal district court in Virginia ruled that an employer does not have to audit or verify the accuracy of employees’ monthly tips reports. In this case, the IRS asserted that employees were understating the full amount of tips received from club members on Form 4070. The court held for the employer, stating that the employer was only responsible for distributing Form 4070 and its instructions to employees for them to complete and return to the employer; the employer had no responsibility to ensure that the amounts were accurate. The court further stated that, absent congressional action, the investigative burden should not be borne by the employer.

The opposite result was reached in *330 W. Hubbard Restaurant Corp. v. United States*.⁷⁹ Although both parties agreed that it was the usual practice in the restaurant industry for employers to rely on their employees to furnish an accurate statement of the tips received, the failure of employees to file accurate reports of their tip income did not insulate the employer from its obligation to pay employer FICA taxes on the unreported tip income.

D. *Are Tips Subject to FICA?*

Section 3121 determines whether remuneration paid for employment constitutes wages for purposes of FICA. The term “wages” means all remuneration for employment, unless specifically excepted under § 3121(a). Tips are considered wages unless they are paid in a medium other than cash or are cash tips of less than \$20 in any calendar month.⁸⁰ In 1965, Congress added §§ 3121(a)(12) and 3121(q) to give employees the benefit of the Social Security system for tip income by

⁷⁷ Forms are available in IRS Pub. No. 1244 (Employee’s Daily Record of Tips and Report to Employer) (rev. Aug. 2005).

⁷⁸ *Norfolk Yacht and Country Club v. United States*, 75-2 USTC ¶ 9849 (E.D. Va. 1975).

⁷⁹ *330 W. Hubbard Rest. Corp. v. United States*, 203 F.3d 990 (7th Cir. 2000).

⁸⁰ I.R.C. § 3121(a)(12).

requiring employees (not employers) to pay FICA tax on tip income.⁸¹ Under § 3121(q), tips received by an employee are considered remuneration from employment for Social Security purposes and deemed paid to the employee at the time reported by the employee to the employer. In 1987, § 3121(q) of the Code was amended to additionally require employers to pay the employer's share of FICA taxes on tip income.⁸² Congress, in 1993, enacted some relief to employers from paying a matching FICA tax on tips by allowing a credit for FICA paid on employees' tips.⁸³ The nonrefundable credit is calculated on Form 8846 (Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips), which is attached to the employer's tax return and filed with the IRS.⁸⁴

Revenue Ruling 2012-18⁸⁵ provides guidance on employee and employer obligations regarding FICA taxes on tips received by employees. An employee must pay his share of FICA taxes on tips reported to the employer, and the employer then withholds the employee's share of FICA taxes on the reported tips from the employee's wages or from funds provided by the employee.⁸⁶ The employee is also liable for his share of FICA taxes on unreported tips, which are shown on Form 4137 (Social Security and Medicare Tax on Unreported Tip Income) and attached to the employee's Form 1040 (U.S. Individual Income Tax Return). The employee is subject to a penalty for failure to report tips under § 6652(b).

The employer must pay the employer's share of FICA taxes on tips received by an employee.⁸⁷ The employee is deemed to have received the remuneration upon presenting a written statement of tips to her employer. If the employee fails to report tips to her employer, the employer is not liable for either the employer or the employee's share of FICA taxes on the unreported tips until the IRS issues a notice and demand under § 3121(q),⁸⁸ which alerts the employer to the tips reported to the IRS by an employee on Form 4137.

E. *Can the IRS Use an Estimated Method to Calculate Unreported Employee Tips?*

In *United States v. Fior D'Italia, Inc.*,⁸⁹ the U.S. Supreme Court reversed a decision of the Ninth Circuit Court of Appeals and permitted the IRS to use an estimated method to calculate unreported employee tips to collect underpaid FICA taxes. This method was simpler and used a single factor as compared to the multiple factors the McQuatters Formula incorporated to reconstruct tip income.⁹⁰ The

⁸¹ Section 209 of the Social Security Act was amended to include as remuneration tips received by an employee in the course of his employment. Pub. L. No. 89-97, § 313, 79 Stat. 286 (1965), effective for tips received by employees after 1965.

⁸² Pub. L. No. 100-203, § 9006(b)(1), 101 Stat. 1330 (1987).

⁸³ I.R.C. § 45B; Pub. L. No. 103-66, § 13443(a), 107 Stat. 312 (1993).

⁸⁴ Only tips received for food or beverage consumption are taken into account. I.R.C. § 45B(b)(2).

⁸⁵ Rev. Rul. 2012-18, 2012-26 I.R.B. 1032.

⁸⁶ *Id.* at Q&A 4.

⁸⁷ I.R.C. § 3111.

⁸⁸ *See also* I.R.C. §§ 3111(a), 6053(a).

⁸⁹ *United States v. Fior D'Italia, Inc.*, 536 U.S. 238 (2002).

⁹⁰ *See* discussion of the McQuatters Formula *supra* text accompanying notes 13–14.

restaurant employer argued that the Code did not permit the IRS to use an “aggregate estimation” method to arrive at tip underreporting and that the IRS had to separately audit each employee before assessing the employer.⁹¹ If the separate audit of each employee revealed a difference in total employee tips reported, then and only then could the IRS make an additional assessment against the restaurant. The position of the IRS was that the Code and prior cases, such as *McQuatters v. Commissioner*,⁹² allowed the use of the aggregate method to estimate total tip income to assess FICA taxes and did not require prior audits of each employee before making an assessment.⁹³ Citing § 446(b), the Court determined that if a taxpayer uses an accounting method that does not “clearly reflect income,” the government can compute taxable income using a method that does reflect income.⁹⁴ The court also noted that the IRS may make assessments and estimates using any reasonable method to determine the FICA taxes due from the employer.⁹⁵

In another case, the Eleventh Circuit Court of Appeals permitted the IRS to use a method to approximate unreported employee tips.⁹⁶ The method calculated the unreported tips in the aggregate for all employees, rather than at the individual employee level, to determine the employer’s share of FICA taxes. In holding for the IRS, the court stated,

We agree that it is the employee’s responsibility to insure that he is properly credited for all his wages by accurately and completely reporting tips. We are concerned, however, that basing the employer’s share of FICA taxes exclusively on employees’ reported tips would provide incentive to the employer to discourage accurate reporting or ignore blatantly inaccurate reporting by the employees so that the employer could pay less FICA tax.⁹⁷

In holding for the IRS, the Eleventh Circuit reversed and vacated the opinion of the district court,⁹⁸ which had held that the IRS’s assessment of the employer’s share of FICA taxes was invalid because it did not calculate the individual employees’ underreporting. The appeals court analyzed the language and structure of both the Code and the Social Security Act to reach a determination that an employer can be assessed its share of FICA taxes on employee tips even if the employee fails to report all tips.

⁹¹ See *Fior D’Italia*, 536 U.S. at 242.

⁹² *McQuatters v. Comm’r*, 32 T.C.M. (CCH) 1122 (1973).

⁹³ See *Fior D’Italia*, 536 U.S. at 244.

⁹⁴ *Id.* at 246.

⁹⁵ *Id.* at 238.

⁹⁶ *Morrison Rests., Inc. v. United States*, 118 F.3d 1526 (11th Cir. 1997).

⁹⁷ *Id.* at 1530.

⁹⁸ *Morrison Rests., Inc. v. United States*, 918 F. Supp. 1506 (S.D. Ala. 1996).

F. *What If Reported Tips are Greater than an Employee's Wages and Insufficient to Cover FICA Taxes?*

If an employee's wages are insufficient to cover FICA taxes on reported tips, the employee can give his employer the funds to make up the difference.⁹⁹ If an employee does not pay his employer the funds to pay FICA taxes on reported tips, the employer treats that difference as "uncollected FICA taxes" and reports the amount on the employee's Form W-2 (Wage and Tax Statement), Box 12 (Code A represents uncollected Social Security Taxes on tips and Code B uncollected Medicare taxes).¹⁰⁰ The employee pays that tax with his Form 1040, as indicated on Schedule 2, Line 8c.¹⁰¹

G. *What Tip Reports Must an Employer File?*

All employers of establishments where tipping is customary must comply with the tip reporting requirements of § 6053(b), including annually providing their employees with a Form W-2 that lists any uncollected FICA taxes on tips. Additional reporting requirements apply to employers that fall under the "large food or beverage" classification, which are food and drinking places with ten or more employees in which tipping by patrons is routine.¹⁰² Such employers that have more than one location must include employees at all locations to determine if they have more than ten employees.¹⁰³ A newly established business falls under this classification if, during any two successive months, all employees (both tipped and non-tipped) work on average more than 80 hours per day.¹⁰⁴

Large food or beverage employers file Form 8027 (Employer's Annual Information Return of Tip Income and Allocated Tips) annually to report at least 8 percent of their gross revenue as tip income.¹⁰⁵ The gross revenue does not include revenue that the restaurant earns from service charges of 10 percent or more or revenue it earns from carryout orders.¹⁰⁶ If the total of all employee-reported tips is less than 8 percent of the restaurant's gross revenue, the employer must allocate the shortfall among tipped employees under one of three methods. The shortfall can be allocated based on a good-faith written agreement with the tipped employees, a method based on the number of hours worked (but only if there are less than 25

⁹⁹ Treas. Reg. § 31.3102-3(a)(3).

¹⁰⁰ Treas. Reg. § 31.6053-2; *See* instructions for Form W-2 (2019).

¹⁰¹ Treas. Reg. §§ 31.3102-3(d)(2), 31.6053-2(c); IRS Pub. No. 531 (Reporting Tip Income) (2019) at 6.

¹⁰² Generally, under Regulation §§ 31.6053-3(j)(7) and 31.6053-3(j)(18), tipping is not considered customary for a cafeteria-style operation or for an establishment that imposes a 10-percent or greater service charge on at least 95 percent of total sales (other than carryout). A cafeteria-style operation is a food or beverage business that is primarily self-service and in which the total cost of food or beverages selected by a customer is paid prior to the customer being seated. If tipping is not considered customary, the food or beverage operation is not a large food or beverage establishment.

¹⁰³ I.R.C. § 6053(c)(4); Treas. Reg. § 31.6053-3(j)(9).

¹⁰⁴ Treas. Reg. § 31.6053-3(i).

¹⁰⁵ I.R.C. §§ 6053(c)(1), 6053(c)(3).

¹⁰⁶ I.R.C. § 6053(c)(6).

full-time employees in all categories), or the gross receipts method.¹⁰⁷ If the actual percentage of tips received by an employer is less than 8 percent of the establishment's gross revenue, a petition may be filed with the local IRS district director to request a reduced rate, but not below 2 percent.¹⁰⁸

Because the allocation to employees determined on Form 8027 involves no actual payments, the employer does not withhold on the additional tip income and is responsible for the employer's share of FICA taxes. The allocated tips are reported on the employee's Form W-2 in Box 8, so that the employee can pay his share of FICA and income taxes with his Form 1040. The employee uses Form 4137 to pay his share of FICA taxes on the allocated tips.¹⁰⁹

III. DO THE CURRENT TIP REPORTING RULES ADDRESS THE NONCOMPLIANCE PROBLEM?

A. *The TIGTA Report's Recommendations*

According to the TIGTA Report, the IRS is not addressing billions of dollars in tip income reporting noncompliance and is not enforcing all tip agreements.¹¹⁰ Revenue agents assigned to the NTRCP spend 61 percent of their time reviewing terms of tip agreements for the gaming industry.¹¹¹ These tip agreement reviews are not audits and do not result in proposed adjustments. Revenue agents spend only 31 percent of their time conducting audits of employer tip compliance.¹¹² According to the IRS, employment tax tip audits are initiated when it is determined that an employer without a tip agreement is reporting low or zero tips on its Form 941, Employer's Quarterly Federal Tax Return, if tipping is customary in the employer's industry.¹¹³

TIGTA also found that 1,971, or approximately 30 percent of the 6,513 businesses with tip agreements that filed tax returns for 2016, had projected unreported tips of approximately \$1.66 billion.¹¹⁴ Almost 87 percent, or 1,711 of the 1,971 businesses, were from three main industries: limited-service restaurants (914), full-service restaurants (679) and personal services (118).¹¹⁵ Employers with TRAC agreements accounted for 815, or around 41 percent, of this noncompliance, representing approximately \$1.2 billion, or roughly 72 percent, of the \$1.66 billion in projected unreported tips.¹¹⁶ Included in those businesses were 47 full-service

¹⁰⁷ I.R.C. § 6053(c)(3)(B); Treas. Reg. § 31.6053-3(d). Details on making the calculations are contained in the instructions for Form 8027.

¹⁰⁸ Treas. Reg. § 31.6053-3(h)(1).

¹⁰⁹ I.R.C. §§ 3121(q), 6053(c)(3); Treas. Reg. §§ 31.6053-3(a), 31.6053-3(d), 31.6053-3(j)(3).

¹¹⁰ TIGTA REPORT, *supra* note 3. TIGTA's examination covered data during fiscal years 2013–2017 and was performed during the period August 2017 through June 2018.

¹¹¹ *Id.* at 7.

¹¹² *Id.*

¹¹³ *Id.* at 3.

¹¹⁴ *Id.* at 8.

¹¹⁵ "Personal services" include beauty salons and barber shops; cosmetics, beauty supply, and perfume stores; and all other personal services. TIGTA REPORT, *supra* note 3, at 9 note 24.

¹¹⁶ TIGTA REPORT, *supra* note 3, at 9.

restaurants with potential underreported tips of over \$1 million each.¹¹⁷ Despite the noncompliance, the IRS provided tip income audit protection to those potentially noncompliant businesses and employees, which meant they were not subject to challenge on audit regarding tips they reported as wages. In tipped businesses where no tip agreement is in effect, there is an even higher risk of noncompliance. TIGTA determined there were 15,771 employers with \$6.3 billion in projected unreported tip income for tax year 2016, including 676 employers that underreported by over \$1 million each.¹¹⁸

NTRCP completed only 34 tip examinations of employers in fiscal year 2016 and 57 in fiscal year 2017.¹¹⁹ The NTRCP prioritized the renewal of lower-risk GITCAs and TRDAs over higher-risk compliance reviews of TRACs and tip examinations. Since fiscal year 2013, the NTRCP completed 875 GITCA and TRDA renewals, compared with 262 tip examinations and 53 TRAC reviews (in fiscal year 2017, there were 65,000 TRACs in place).¹²⁰

The TIGTA Report highlighted that the number of IRS examiners assigned to the NTRCP was not adequate. Although the NTRCP employees are responsible for oversight of an industry that represents 10 percent, or \$23 billion of the estimated \$235 billion individual income tax underreporting Tax Gap for 2006, only 41 or 0.46 percent of the 8,847 IRS examination employees were assigned to the NTRCP in 2016.¹²¹ Without employment tax tip examinations, the IRS is less likely to bring tip income underreporters into reporting compliance. In addition, there is less incentive for these businesses to establish a tip agreement because the risk of an audit is low.

TIGTA made nine recommendations in the TIGTA Report to improve the administration of tip agreements and examinations. First, the NTRCP should use a risk-based approach to prioritize its field examination resources and focus on higher-risk work with the greatest impact to reporting compliance.¹²² A second recommendation is to have NTRCP examiners spend less time renewing low-risk GITCAs and renew and extend agreements only if annual monitoring shows that the employer complies with reporting and payments.¹²³ Also, NTRCP examiners should use data analysis and sampling to monitor employer compliance with tip agreements.¹²⁴ By using this methodology, the examiners can focus on tip agreements with projected unreported tips with a higher dollar value.

¹¹⁷ *Id.* at 10.

¹¹⁸ *Id.* at 11.

¹¹⁹ *Id.*

¹²⁰ *Id.* at 2–6.

¹²¹ *Id.* at 12.

¹²² The NTRCP is positioned under SB/SE Specialty Examination function's Employment Tax Program. The tip examination cases selected by the NTRCP include employers from both the SB/SE and Large Business and International (LB&I) Divisions of the IRS. SB/SE serves businesses with less than \$10 million in assets and LB&I serves larger businesses with assets in excess of \$10 million. Although LB&I businesses tend to result in a much higher audit adjustment, in 2016, only 15 percent of the total examination cases that were closed were LB&I businesses, but they accounted for 96 percent of the total FICA tax adjustments. *See* TIGTA REPORT, *supra* note 3, at 41.

¹²³ *Id.*

¹²⁴ *Id.* at 42.

Another recommendation advised the IRS to develop a risk-based case selection methodology that uses historical statistics and data analysis to identify the highest risk tip examination cases annually.¹²⁵ The IRS should use the NTRCP Centralized Employment Tax Operations (CETO)¹²⁶ function to complete the notice and demand letter process for closed tip examinations when field examination resources are limited. The CETO function already performs this work for the Form 4137 tip compliance work stream and thus would not be a new process.¹²⁷

TIGTA additionally recommended that the IRS update the Internal Revenue Manual's provisions on tip examination¹²⁸ to clarify the requirements for expanding the scope of a tip examination to prior and/or subsequent years; clarification is also needed on the requirements for documenting the reasons for expanding or limiting the examination's scope. Another recommendation was to reduce the number of approvals required to revoke tip agreements with noncompliant businesses.¹²⁹ TIGTA also recommended that the Internal Revenue Manual be updated to provide more criteria and examples of when a tip agreement should be revoked with a noncompliant business.¹³⁰ Further, an Internal Revenue Manual update is needed to list criteria and examples on how to perform compliance reviews, including the Form 8027 analysis of unreported tips.¹³¹

The final TIGTA recommendation was to ensure that Form 4137 compliance cases are addressed in the CETO function's annual work plans, including the cases related to 2013–2015, which involved more than \$1.5 million in potential increased FICA tax revenue. This recommendation asked the IRS to include high-risk Form 4137 filings by Indian Tribal Governments in the SB/SE CETO work plan as resources permit.¹³²

The IRS agreed with all the recommendations in the TIGTA report and concurred with taking specific actions to improve the identification of higher-risk work, consider the extent of compliance in renewing GITCAs, improve its tip agreement selection process, review the notice and demand process for closed tip examinations to determine if CETO resources can be used, update the Internal Revenue Manual for tip examination, streamline the approval process to revoke tip agreements, and establish better criteria for the revocation of a tip agreement.¹³³

¹²⁵ *Id.*

¹²⁶ In addition to the IRS examiners assigned to the NTRCP, a group of 24 tax examiners in the Centralized Employment Tax Operations (CETO) function located in Detroit, Michigan, work mainly notice and compliance workstreams for the NTRCP. Examples of work performed by the CETO function are Form 4137 Compliance; Form 8027 Nonfiler Soft Notices; Unreported Tip Income Soft Notices; and Form 941/944 Mismatch.

¹²⁷ See TIGTA REPORT, *supra* note 3, at 43.

¹²⁸ I.R.M. 4.23.7.7 (Jan. 22, 2010).

¹²⁹ See TIGTA REPORT, *supra* note 3, at 43.

¹³⁰ I.R.M. 4.23.7.10.1 (Jan. 22, 2010).

¹³¹ See TIGTA REPORT, *supra* note 3, at 44.

¹³² *Id.* at 45.

¹³³ TIGTA REPORT, *supra* note 3, at 41–44.

B. *Are the Recommendations in the TIGTA Report Sufficient?*

The implementation of the TIGTA recommendations would go a long way to increasing compliance with tip reporting. An additional improvement would be to not only focus on higher-risk work with the greatest impact, but to assign more revenue agents and examiners to the NTRCP function. Currently, agents are expected to perform the tasks of examining employers without tip agreements and employer education outreach, as well as approving, renewing, and adding more locations to tip agreements. A risk-based approach would likely have limited impact unless more revenue agents are assigned to the NTRCP.

The NTRCP examiners spend a disproportionate amount of time performing full tip rate reviews prior to renewing low-risk GITCAs. In recently issued guidance, the IRS provides procedures to renew GITCAs for an additional three years without a full tip rate review.¹³⁴ This guidance will enable the NTRCP to divert resources to higher-risk areas. Further, due to limited resources, the NTRCP has been using a single analyst to manually identify tip examination cases without using a strategic or risk-based approach to identify those with the highest potential of unreported tips. TIGTA's recommendation to use data analysis and sampling to monitor all types of tip agreements would help identify taxpayers that need a compliance review.

Using the NTRCP CETO function to complete the notice and demand letter process for closed tip examinations is an excellent practical solution. The CETO function mainly assists the NTRCP with Form 4137 compliance, sending notices to employers who are not filing Form 8027 and to those with a Form 941 and Form 944 (Employer's Annual Federal Tax Return) mismatch. Since notice and compliance work does not require specialized skills, there is no need to assign a revenue agent to perform this work.

Updating the tip examination portion of the Internal Revenue Manual, as recommended in the TIGTA Report, will provide clarity to staff assigned to tip compliance reviews. The IRS *Employment Tax Combined Tip Gaming Training Student Guide*¹³⁵ provides details of what is required during a compliance review, but those procedures have not been incorporated into the Internal Revenue Manual. Reducing the number of approvals required to revoke tip agreements with noncompliant employers will help conclude cases quickly and allow scarce resources to be allocated to other high-risk areas. In addition, updating the Internal Revenue Manual with examples on how to perform compliance reviews and when to revoke a tip agreement will provide clarity to staff assigned to those reviews. The final TIGTA recommendation to ensure that Form 4137 compliance cases are addressed in the CETO function's annual work plans and high-risk Form 4137 filings by Indian Tribal Governments included in the SB/SE CETO work plan will increase FICA tax revenue.

¹³⁴ See IRS, TE/GE-04-0720-0009, Memorandum for all Indian Tribal Governments Employees (July 15, 2020).

¹³⁵ IRS, Trng 28136-002, Catalog Number 53650W, EMPLOYMENT TAX COMBINED TIP GAMING TRAINING STUDENT GUIDE (Aug. 2012); I.R.M. 4.23.7.10.6.3(9) (Dec. 18, 2012).

CONCLUSION

One hundred percent compliance in tip reporting is impossible, because the enforcement efforts of the IRS are limited by resource constraints and the size and rapid growth of the tipping industry, particularly the food and beverage industry. In its repeated efforts to tackle the compliance problem, the IRS has had limited success. The TIGTA Report demonstrates that the IRS is not using its limited resources effectively and cannot increase tip reporting compliance unless it assigns its trained examiners to higher-risk areas to help generate greater dollar value adjustments. The IRS should put greater emphasis on tip examinations of businesses that fall under the LB&I classification, which have resulted in the largest FICA tax adjustments. More tip examinations are needed, because businesses without tip agreements know the risk of being audited is low. The IRS must take a balanced approach that leverages education and voluntary tip agreements and allocates its trained examiners to high-risk areas to maximize enforcement efforts. Collectively, this will achieve compliance in the most efficient manner.