

Office of Chief Counsel
Internal Revenue Service
memorandum

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date: December 04, 2017

to: Division Counsel/Associate Chief Counsel
(Tax Exempt & Government Entities)
Attn: Linda Azmon

from: Paul J. Carlino
Branch Chief
CC:TEGE:EOEG:ET1
(TEGE Associate Chief Counsel)

subject: Advice on Unreported Tip Income and IRC Sections 7436 and 3121(q)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. Whether cash amounts distributed to individuals from “tip boxes” are properly classified as tips under the Internal Revenue Code (Code) and subject to Federal Insurance Contributions Act (FICA) tax.
2. Whether cash amounts distributed to individuals from “tip boxes” are subject to notice and demand procedures under section 3121(q)¹ or whether taxes on cash amounts should be included in Table 3 of Letter 3523, *Notice of Employment Tax Determination under IRC § 7436*.²

¹ All section references in this memo are to the Internal Revenue Code of 1986 unless otherwise noted.

² Letter 3523, formerly titled “*Notice of Determination of Worker Classification*” has been renamed “*Notice of Employment Tax Determination under IRC § 7436*”. For purposes of this memo, we refer to the notice required to be issued to a taxpayer pursuant to section 7436 as “Letter 3523.”

CONCLUSIONS

1. The cash amounts distributed to individuals from “tip boxes” are properly classified as tips pursuant to rules stated in Rev. Rul. 2012-18³ and are wages subject to FICA tax.
2. The cash amounts distributed to individuals from “tip boxes” are tips and thus subject to notice and demand procedures under section 3121(q).

FACTS

Taxpayer engages individuals to perform services at the Taxpayer’s request and on the Taxpayer’s premises. Taxpayer treats the individuals as volunteers and does not directly pay the individuals any form of compensation or benefits for their services. Taxpayer acknowledges, however, that the individuals receive cash payments from amounts contributed by customers. The cash amounts are deposited by customers in “tip boxes” placed by Taxpayer in the vicinity of where the individuals perform services.

Taxpayer places the “tip boxes” to encourage customers to contribute cash amounts to the individuals. Taxpayer does not require customers to make cash contributions and customers have discretion on how much cash to contribute (including zero contribution).

The amount of cash in the “tip boxes” is distributed at the end of each shift. Individuals who performed services during a shift determine how to allocate the tip box amount between all of the individuals who performed services during that shift. Although Taxpayer is aware that customers place cash in the “tip boxes” and that the individuals working each shift distribute the cash among themselves, Taxpayer does not have a system in place for individuals to provide written statements reporting the cash amounts received to Taxpayer, and there is no evidence that Taxpayer has knowledge of the specific amount of cash received by each individual. Taxpayer does not issue Forms W-2, *Wage and Tax Statement*, to the individuals and has not included any wages or taxes in connection with their services on Form 941, *Employer’s QUARTERLY Federal Tax Return*.

During the course of an audit, the Service determines that Taxpayer has the right to direct and control the individuals as they perform services and that the individuals should be classified as employees of Taxpayer for purposes of FICA taxes. In addition to its worker classification determination, the Service proposes a FICA tax liability related solely to the unreported cash amount received by the individuals.⁴ The Service issues Letter 3523 to Taxpayer at the conclusion of the audit, notifying Taxpayer of its worker classification determination.

³ 2012-26 I.R.B. 1032.

⁴ For purposes of simplicity, this memo does not address any determination made by the Service with regard to Section 530 of the Revenue Act of 1978 or any potential Federal Unemployment Tax Act (FUTA) or income tax withholding liability.

Your inquiry relates to whether the cash amounts are “tips” subject to notice and demand procedures under section 3121(q) or whether tax on the tip box amounts should be included in Table 3 of Letter 3523, which lists the proper amount of employment tax, additions to tax, and penalties with respect to payments made to individuals who are being reclassified as employees.

LAW AND ANALYSIS

Sections 3101 and 3111 impose FICA taxes on employees and employers, respectively. FICA taxes are imposed on “wages” as that term is defined in section 3121(a). Section 3121(a) defines wages as all remuneration for employment with certain specific exceptions. Section 3121(a)(12)(A) excludes “tips” from the definition of wages if paid in any medium other than cash. Section 3121(a)(12)(B) excludes cash tips received by an employee in any calendar month in the course of the employee’s employment by an employer, unless the amount of the cash tips is \$20 or more.

Section 3102(a) requires employers to deduct from wages and pay over the employee portion of the FICA tax. However, section 3102(c)(1) provides a special rule applicable to tips. It states, in relevant part, the employer’s obligation to deduct employee FICA tax from tips which constitute wages is applicable only to such tips as are included in a written statement furnished by the employee to the employer pursuant to section 6053(a), and only to the extent that collection can be made by the employer by deducting the amount of the tax from wages of the employee (excluding tips) as are under control of the employer, or from other funds made available by the employee for this purpose.

Under section 3121(q), tips received by an employee in the course of the employee’s employment are considered remuneration for that employment (and are deemed to have been paid by the employer for purposes of the employer portion of the FICA taxes imposed by sections 3111(a) and (b)). For purposes of determining the timing of the employer’s FICA tax liability, the remuneration is deemed to be paid when a written statement including the tips is furnished to the employer by the employee pursuant to section 6053(a). However, if the employee did not furnish the statement, or if the statement furnished was inaccurate or incomplete, the remuneration is deemed to be paid on the date on which the Service issues a notice and demand under section 3121(q) for the taxes to the employer.

The characterization of a payment as a “tip” by the employer is not determinative for purposes of determining when the employer portion of FICA arises. Section 31.3121(a)-(1)(c) of the Employment Tax Regulations provides that the name by which the remuneration for services is designated is immaterial. Thus, designating a payment as a tip is irrelevant if the amount is paid as compensation by an employer for services

performed by its employee. For example, Rev. Rul. 59-252⁵ holds that the payment by a customer of a fixed charge imposed by a banquet hall that is then distributed by the banquet hall to the employees who render services (e.g., waiter, busser, and bartender) is a service charge and not a tip. To the extent any portion of a service charge paid by a customer is distributed to an employee, it is wages for FICA tax purposes at the time it is distributed.

Tips are not defined in the Code or regulations; however, published guidance addresses how to determine whether a payment is a tip. Rev. Rul. 2012-18 reaffirms the factors first stated in Rev. Rul. 59-252 which are used to determine whether payments constitute tips. Rev. Rul. 2012-18 provides that the absence of any of the following factors creates a doubt as to whether a payment is a tip:

- 1) payment must be made free from compulsion;
- 2) the customer must have the unrestricted right to determine the amount;
- 3) the payment should not be the subject of negotiation or dictated by employer policy; and
- 4) generally, the customer has the right to determine who receives the payment.

Under the facts presented, the four factors set forth in Rev. Rul. 2012-18 have been satisfied. The fact that the cash contributions are collected by the individuals who work during the shift and pooled for purposes of distribution among them satisfies the fourth factor. The customers generally have the right to determine who receives the payment when the tipped amounts are pooled and the individuals working each shift distribute the cash among themselves.

Once the amounts have been properly identified and characterized as tips, the timing of the FICA rules for employer tax liability purposes can be applied. Because the tips have not been reported to the taxpayer pursuant to section 6053(a), they are deemed to be paid on the date on which the Service issues a notice and demand under section 3121(q) for the taxes to the taxpayer. Thus, the tips are not subject to the employer share of FICA tax until the Service issues a notice and demand under section 3121(q).

The Service should issue Letter 3523 to Taxpayer based on the worker classification determination, and should identify in Table 1 the individuals the Service determined should be reclassified as employees. However, tax on the cash amounts received by the individuals should not be included in Table 3 of Letter 3523 because the tips are deemed paid only after the Service issues a notice and demand under section 3121(q). Thus, the only issue that would be subject to Tax Court jurisdiction would be the proper worker classification of the individuals listed in Table 1.

If an amount properly characterized by an employer as a tip was reported by the employee to the employer in accordance with section 6053(a), it would be deemed to be

⁵ 1959-2 C.B. 215.

paid at the time the written statement was made and tax on the amount should be included in Table 3 at the time Letter 3523 was issued. Similarly, if an amount characterized by an employer as a tip was determined not to be a tip (for example, it was a service charge) tax on the amount should be included in Table 3 at the time Letter 3523 was issued.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 317-6798 if you have any further questions.