Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Elizabeth Laverty
Supervisory Internal Revenue Agent
Field Operations West
Team 1165-San Jose
Attn: Jim Carey

from: Janine Cook
CC:TEGE, Branch Chief

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subject:

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

This is in response to your inquiry regarding the proper tax treatment of “tip jar” amounts distributed to employees and whether section 3121(q) of the Internal Revenue Code (Code) applies under the facts you describe.

LEGEND

Company =

State =

Product =

x =

Year Y =

ISSUE

Under the facts described herein, are amounts placed in “tip jars” at Company stores in State treated (1) as wages subject to tax under the Federal Insurance Contributions Act (FICA) at the time the amounts are distributed to the employees, or (2) as tips governed by section 3121(q) of the Code so that unreported tips will not be subject to the employer share of FICA tax until the Service makes a notice and demand for the taxes from Company.

CONCLUSION

The amounts placed in “tip jars” at Company stores in State under the facts described herein are tips governed by section 3121(q) so that unreported tips will not be subject to the employer share of FICA tax until the Service makes a notice and demand for the taxes from Company.

FACTS

Company is a corporation engaged in State in retail sales of Product and related items for which customers often provide additional cash amounts as compensation to those serving them, typically viewed as tips. Company has set forth its policy and the required procedures regarding these cash amounts left by customers at Company locations in several Company manuals. Pursuant to Company policy, each location must have at least one specified container placed near a register to serve as a “tip jar” for collecting cash amounts left by customers. These tip jars may not be used to make change according to Company manuals. The cash amounts cannot be designated for any particular employee.

A Company manual provides that, in order to ensure the security of the cash placed in the tip jar (“tip jar amounts”) during normal hours of operation, each day’s tip jar amounts in each store are maintained in a locker, drawer or other suitable and securable location during the business hours to provide for authorized access to the tip jar amounts without having to open the store safe. At closing, the day’s tip jar amounts are gathered, logged and placed in the store safe following the tip jar security procedure found in the Company manual. Specifically, once the tip jar amounts are counted, they are recorded in the cash management log, the amounts are placed in a drop bag and recorded on a tip log and secured in the safe. Drop bags can only be accessed when tip jar amounts are being counted for weekly distribution or being changed into bills to increase space in the safe.

The tip jar amounts are distributed only to employees with job positions which Company has determined are non-management. The store manager and the assistant store manager also participate in providing services to the customers but are not allowed to share in any tip jar amounts. There are no restrictions on the amount that can be paid out to employees.

The tip jar amounts are required by Company to be distributed weekly. As part of the weekly distribution process, a store manager prints the time sheet for the week for the store, sorted by employee, and provides it to the employee who is counting and distributing tip jar amounts ("designated employee"). According to a Company manual, store managers and assistant store managers may not count or distribute tip jar amounts. The designated employee counting the tip jar amounts is required by Company to do so in the back of the store while on Company time.

Procedures specified in Company manuals require that each week the designated employee adds together the "tippable" hours (generally, only hours spent serving customers) from the time sheet prepared by a store manager. The designated employee calculates the weekly amount that each employee should receive based on his or her allocable share of the number of tippable hours worked. The designated employee places the weekly amount determined for each employee in a sealed envelope, labels the envelope with the employee's name and then places each envelope in the store safe, in a secured compartment, until the employee is available to take possession of it. The amounts distributed must be recorded on the tip removal log with the "cash controller" (a non-management employee is designated weekly as the cash controller).

In Year Y, Company estimated that employees received at least x per hour from the tip jar and reported this to the IRS on the employees' behalf on Forms W-2, Wage and Tax Statement. Company does not request, and employees do not provide, reports to Company of actual amounts distributed to them from the tip jar. Company requests that employees report amounts to the IRS if they earn more then the x per hour.

LAW AND ANALYSIS

Sections 3101 and 3111 of the Code impose FICA taxes on "wages" as that term is defined in § 3121(a). Section 3121(a) defines "wages" for FICA purposes as all remuneration for employment with certain specific exceptions. Section 3121(a)(12)(A) excludes tips 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.

FICA taxes consist of the Old-Age, Survivors, and Disability Insurance (OASDI) tax and the Hospital Insurance tax. These taxes are imposed equally on both the employer under section 3111(a) and (b) and on the employee under section 3101(a) and (b). The amount of wages for OASDI purposes is limited to an annually adjusted amount ($106,800 for 2009) under section 3121(a). Accordingly, once an employee's wages reach this annually adjusted amount (the wage base), the OASDI portion of the FICA tax does not apply thereafter.

Section 3102(a) of the Code requires employers to deduct and pay over the employee portion of the FICA tax. However, section 3102(c)(1) provides a special rule applicable to tips. It states, for purposes relevant here, that the withholding requirement of subsection (a) is applicable only to such tips as are included in a written statement furnished 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 paid to the employee (excluding tips). Employment Tax Regulations section 31.3102-3(a)(2) provides that an employer is required to deduct and withhold the tax on tips constituting wages only for those tips the employee reports to the employer in a written statement as required under section 6053(a).[1]

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 section 3111(a) and (b)). 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 either did not furnish the statement or if the statement furnished was inaccurate or incomplete, in determining the employer's liability in connection with the FICA tax imposed on the employer by section 3111 with respect to the tips, the remuneration is deemed, for purposes of Subtitle F, to be paid on the date on which notice and demand for the taxes is made to the employer by the Secretary.

For purposes of the special rules set forth above, tips are not defined in the Code or regulations. However, published guidance is instructive in determining what are and are not tips for these purposes. In Rev. Rul. 59-252, 1959-2 C.B. 215, negotiations between a hotel and a customer for the use of the hotel's banquet facilities were not restricted to the cost of meals and beverages but also included or contemplated additional amounts for distribution to employees of the hotel. The revenue ruling held that such amounts may not be treated as tips or gratuities but are considered as a service charge which constitutes wages for federal employment tax and income tax withholding purposes. Although Rev. Rul. 59-252 determined that the amounts at issue were service charges rather than tips, the ruling provides three criteria which indicate when amounts received are tips: 1) the contributions of money must be made “free from compulsion”; 2) the customer must have “unrestricted right to determine the amount thereof”; and (3) the contributions “should not be the subject of negotiation or dictated by employer policy.” In essence, “the customer has the right to determine precisely who shall be the recipient of his or her generosity. The absence of any of these factors

[1] Section 6053(a) of the Code provides that “[e]very employee who, in the course of his employment by an employer, receives in any calendar month tips which are wages (as defined in section 3121(a) or section 3401(a)) or which are compensation (as defined in section 3231(e)) shall report all such tips in one or more written statements furnished to his employer on or before the 10th day following such month. Such statements shall be furnished by the employee under such regulations, at such other times before such 10th day, and in such form and manner, as may be prescribed by the Secretary.”

creates a serious doubt as to whether the payment is really a tip and indicates that it is in fact a service charge for the use of certain facilities."[2]

Revenue Ruling 64-40, 1964-1 C.B. 68, applies these same criteria to reach a similar conclusion. Revenue Ruling 64-40[3] cites the factors listed in Rev. Rul. 59-252 in finding that amounts donated by members of a non-profit club to a fund held for employees until Christmas was wages but not tips. The funds were solicited by a pledge card that noted the club's board of governors would determine how to distribute the funds. In reaching its conclusion that the amounts were wages but not tips, the revenue ruling notes that the contributions were not made entirely "free from compulsion" and the annual organized fund raising drive was clearly "dictated by employer policy" and the donor had no right to "determine precisely who shall be the recipient of his generosity." The revenue ruling included in its analysis the facts that some of the funds were made to persons with whom the donors would never have contact, the employees expected to share in the fund as an integral part of the wage structure, the club members had a "compelling moral obligation" to donate, and the club exercised great control over the fund.

Revenue Ruling 69-28, 1969-1 C.B. 270, discusses the application of the employment tax rules to amounts paid by customers in various situations. Situation 1 involves an automatic 10 percent charge added to all club member charges. The ruling concludes that the amounts subsequently disbursed to the employees by the club are wages and not tips. The club determines the arbitrary charge; it is not provided as a gratuity. Rather, the automatic charge becomes part of club funds that the club later distributes. By contrast, Situation 2 involves a hotel customer who pays a tip to the waiter by writing the amount on the waiter's check. The hotel then pays the tip to the waiter and charges it to the account of the customer. While the focus of the discussion of Situation 2 involves the specific reporting rules applicable to tips, Situation 2 first distinguishes Situation 1 by noting that the customer determines the amount of the tip and pays it for services rendered to him by the waiter. In fact, Rev. Rul. 59-252 cites S.S.T. 301, the predecessor to Situation 2 in Rev. Rul. 69-28, as consistent with the criteria and conclusion in Rev. Rul. 59-252, noting that the customer was free to determine whether or not he would tip the employee and the amount of the tip and concluding that the amount did not lose its identity as a tip by virtue of the hotel acting as a conduit for providing it to the waiter.

Similarly, General Counsel Memorandum (GCM) 37507 (April 19, 1978), considered whether charge slip tips collected by the employer on behalf of the employees and distributed by the employer to the employees according to employee hours worked must be reported as "wages" paid by the employer for FICA and income tax withholding purposes, regardless of whether such amounts are reported by the employee to the

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[2] See also Rev. Rul. 57-397, 1957-2 C.B. 628.

[3] Revenue Ruling 64-40 principally follows the analysis set forth in General Counsel Memorandum (GCM) 32412 (October 2, 1962).

employer as tips pursuant to section 6053(a) of the Code. Applying the factors in Rev. Rul. 59-252, and principally focusing on the voluntary nature of the amount given, the GCM concluded that charge slip tips collected by the employer on behalf of the employees and distributed by the employer to the employees according to employee hours worked should be viewed as amounting to a tip-splitting arrangement among the employees on whose behalf the employer administers such arrangement. Accordingly, such amounts were tips and included on Forms W-2 only if reported under section 6053(a).

Rev. Rul. 95-7, 1995-1 C.B. 185, Q&A 2, sets forth the specific question of whether section 3121(q) applies in situations in which all tips are required by the employer to be turned over to the employer by the employees, and the employer, in turn, distributes the tips among all the employees. The answer provided is that tips distributed in those situations are wages when paid by the employer. Q&A 2 further provides that section 3121(q) applies only to tips that are received and retained by the employee.

In this case, the contribution of money by Company customers to the tip jars is made free from compulsion, the customer has the unrestricted right to determine the amount, and the contribution is not dictated by employer policy, as discussed in Rev. Rul. 59-252. While the customer cannot determine precisely who will receive the money he or she places in the tip jar, the tip jar amounts satisfy the three criteria of tips set forth in Rev. Rul. 59-252. The tip jar amounts bear no similarity to the service charges in Rev. Rul. 59-252. The contributions do not lose their identity as tips by either the use of a tip jar to collect them or the procedures specified by the Company for its employees to store and distribute them.

As mentioned previously, Rev. Rul. 95-7, Q&A 2, provides that where tips are required by the employer to be turned over to the employer by the employees, and the employer, in turn, distributes the tips among all the employees, the tips distributed are wages when paid by the employer and, therefore, section 3121(q) does not apply. However, the storage and distribution procedures required by the Company do not constitute the same level of control as that exercised by the club over the annual fund solicited and distributed by the club in Rev. Rul. 64-40 or the arbitrary charge obtained and later distributed by the club in Situation 1 of Rev. Rul. 69-28.[4] The procedures do not to any degree compromise the inherent voluntary nature of the amounts provided by Company customers. Accordingly, Q&A 2 of Rev. Rul. 95-7 does not apply to the tip jar amounts.

Based on the totality of the facts and circumstances, the tip jar amounts retain their character as tips governed by section 3121(q) of the Code so that unreported tips will not be subject to the employer share of FICA tax until the Service makes a notice and demand for the taxes from Company.

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[4] In fact, the specific use of employees other than the store manager or assistant store manager to count and distribute the tip jar amounts suggests there is even less Company involvement than the level of employer involvement in the tip-splitting arrangement discussed in GCM 37507 where the employer administered the arrangement on behalf of the employees.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call Linda Conway at (202) 622-0047 if you have any further questions.