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Report to the Honorable David Pryor
United States Senate

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TAX ADMINISTRATION

Tip Income Reporting Can Be Increased

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GAO

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General Accounting Office
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The Honorable David Pryor
United States Senate

Dear Senator Pryor:

This report responds to your request that we review the Internal Revenue Service's (IRS') efforts to improve tip income reporting and the impact of the Tax Equity and Fiscal Responsibility Act of 1982 tip income reporting requirements on both the food and beverage industry and tip income reporting. The report discusses the need for IRS to (1) design an overall strategy for identifying, quantifying, and reducing tip income nonreporting and (2) establish uniform criteria for use in the administration of tax law provisions which allow employers to petition IRS for a reduction from the reporting of 8 percent of gross sales as tip income.

As arranged with your office, unless you publicly announce the report's contents earlier, we plan no further distribution until 14 days from its issue date. At that time, we will send copies to other interested congressional committees and members; the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

Sincerely yours,

W.J. Anderson

William J. Anderson
Assistant Comptroller General

Executive Summary

Purpose

For calendar year 1981, the latest year for which information is available, IRS estimated that individuals did not report or pay taxes on over $8.5 billion in tip income. According to IRS, this nonreported tip income translated into an estimated nonreporting rate of 84 percent and an estimated tax loss of $2.3 billion. The Tax Equity and Fiscal Responsibility Act of 1982 provided IRS with new measures to help identify nonreported tip income. This act imposed new reporting requirements on the food and beverage industry, which employs the largest percentage of tipped employees.

Senator David Pryor asked GAO to assess the impact of the new reporting requirements on the food and beverage industry and IRS' efforts to increase tip income reporting. GAO's report specifically addresses:

- IRS' initiatives to identify, quantify, and reduce nonreporting of tip income.
- The impact of the new reporting requirements on the food and beverage industry and tip income reporting.

Background

Various types of businesses, such as taxicab companies, beauty parlors, gambling casinos, and food and beverage establishments employ individuals who receive tip income. Department of Labor information shows that in calendar year 1982, there were over 3 million tipped employees, of which 2.3 million (77 percent) were employed by the food and beverage industry. The number of these employees who are affected by the 1982 act, however, is not known. This is because (1) the act applies only to a subset of larger establishments (who may not all be complying) and (2) no readily available data exist on the number of smaller establishments not covered by the act nor on the number of their tipped employees.

Under the 1982 act, certain large food and beverage establishments are required to report certain tip-related information to IRS annually. This information includes the gross receipts from food and beverages, the amount of aggregate charge receipts showing tips, and the tip income which employees report. If this reported tip income is less than 8 percent of gross sales, the establishment must allocate the difference among its directly tipped employees, using one of several possible methods. The establishment must report the allocated amount on each employee's W-2 form but must not withhold taxes from it. The act allows an employer to petition IRS to reduce the allocation rate.

IRS' district offices are encouraged to use information gathering projects to identify income nonreporting, including tip income. The objectives of these projects are to identify potential areas of nonreporting, determine the reason for the nonreporting, and devise the action(s) needed to reduce it. Each IRS region and district independently decides on the approach to be used in pursuing nonreported tip income.

Results in Brief

IRS needs to develop an overall strategy for addressing tip income nonreporting. Of the four IRS regions GAO visited, two were more active and successful in pursuing tip income nonreporting than the others. Given the experience gained from the more active regions and the information provided through and requirements established by the 1982 act, IRS is now in a better position to develop an overall strategy. (See pp. 14 to 21.)

GAO's analysis indicates that tip income reporting has increased since the implementation of the 1982 act's new reporting requirements. Further, food and beverage employer responses to GAO's questionnaire and structured interviews indicate that implementation of these new reporting requirements has not been as costly as originally projected by the food and beverage industry. (See pp. 22 to 26.)

Additionally, GAO found that varying procedures are being used by IRS districts in administering the provision of the 1982 act which allows employers to request a rate reduction from the reporting of 8 percent of gross receipts as tip income. The varying procedures could result in inequitable treatment of taxpayers. (See pp. 27 to 30.)

Principal Findings

IRS Can Better Address Tip Income Nonreporting

On the basis of work performed in 18 district offices within four IRS regions, GAO found that the two regions which were more active in tip income projects conducted a total of 421 projects which resulted in the assessment of about $67 million in additional taxes and penalties for fiscal years 1977 through 1985. In contrast, the two regions which were less active in pursuing nonreported tip income conducted a total of 25 projects which resulted in the assessment of approximately $1 million in additional taxes and penalties for the same time period. (See pp. 15 to 18.)

IRS recognizes that more can be done to improve compliance in tip income reporting and has begun to use data generated as a result of the 1982 act to address the issue. The use of this data, in conjunction with the experience gained by the two active regions in dealing with tip income nonreporting, places IRS in a good position to begin formulating an overall approach for addressing the issue. (See pp. 18 to 21.)

New Requirements Implemented at Less Cost and Tip Reporting Increased

Segments of the food and beverage industry had projected that the average establishment would spend about $6,000 to implement the 1982 act's reporting requirements. However, GAO projected that about 68 percent of the establishments which incurred an initial cost in complying with the requirements experienced a cost of $2,000 or less. About 70 percent of the establishments which experienced recurring costs are also experiencing annual costs of $2,000 or less. Furthermore, GAO's analysis showed that the overall reporting of tip income has increased since implementation of the new reporting requirements. For example, tip income reported to IRS from employers in GAO's sample increased from about $300 million in 1982 to over $600 million in 1983. Further, according to IRS, the 1982 act increased tip income reporting by 108 percent on an annual basis between 1982 and 1983, representing an additional $1 billion in reported tip income for 1983. (See pp. 22 to 26.)

Methods Used for Reviewing Rate Reductions Varied

GAO's work in 18 district offices showed that the procedures used to review the merits of employers' rate reduction requests differed because IRS' National Office has not issued criteria on which to base such a determination. These varying methods produce the potential for inequitable treatment of taxpayers. GAO recognizes that it is not possible to eliminate all of the subjectivity from the rate reduction process, but believes that more standardized instructions on how to analyze supporting documentation can reduce the present level of subjectivity. (See pp. 27 to 30.)

Recommendations

To improve the Service's efforts to reduce the nonreporting of tip income, GAO recommends that the Commissioner of Internal Revenue formulate and implement an overall strategy for reducing tip income nonreporting. In formulating this strategy, the Commissioner should, in conjunction with providing tip income information to the regional and district offices, (1) identify and evaluate, for Service-wide applicability, those detection techniques and tools which have been proven effective in conducting tip income reporting projects and communicate this information to all IRS regions and districts and (2) design and implement an overview and evaluation process to monitor the progress of tip enforcement activities, identify potential problem areas, and devise the action(s) needed to deal with them. (See p. 21.)

To reduce the inconsistencies in the rate reduction process, GAO recommends that the Commissioner of Internal Revenue (1) establish uniform criteria and standard procedures for reviewing employers' requests for a reduction from the reporting of 8 percent of gross receipts as tip income and (2) monitor the implementation of the review process to assure a reasonably consistent Service-wide approach. (See p. 31.)

Agency Comments

IRS generally agreed with the report and has initiatives underway that can be useful in implementing GAO's recommendation to develop an overall strategy for reducing tip income nonreporting. IRS is also implementing GAO's recommendation to reduce the inconsistencies in the rate reduction process. (See app. V.)

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Abbreviations

GAO	General Accounting Office
IRP	Information Returns Program
IRS	Internal Revenue Service
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982

Introduction

The lack of voluntary reporting of tip income has been and continues to be a concern of the Internal Revenue Service (IRS). Its most current estimates indicate that for calendar year 1981, individuals did not report or pay taxes on over $8.5 billion in tip income. Of this amount, about $800 million is attributed to taxpayers who did not file a return and about $7.7 billion represents taxpayers who filed a return but underreported their tip income. According to IRS, the $8.5 billion in unreported tip income translated into an estimated nonreporting rate of approximately 84 percent and a tax loss estimated at $2.3 billion. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Public Law 97-248 (26 U.S.C. 6053(c)), contained provisions to assist IRS in dealing with unreported tip income.

Various types of businesses, such as taxicab companies, beauty parlors, gambling casinos, and food and beverage establishments employ individuals who receive tip income. Department of Labor information shows that for calendar year 1982 there were over 3 million tipped employees, of which 2.3 million (77 percent) were employed by the food and beverage industry. The number of these employees who are affected by the 1982 act, however, is not known. This is because (1) TEFRA applies only to a subset of larger establishments (who may not all be complying) and (2) no readily available data exist on the number of smaller establishments not covered by TEFRA nor on the number of their tipped employees.

IRS' efforts for identifying and eliminating income nonreporting, including tip income, is carried out in four IRS functions—examination, collection, returns and information processing, and criminal investigations. The examination function focuses on filers who underreport their income while the collection function focuses on securing tax returns from individuals who have not filed. The returns and information processing function identifies potential underreporters and nonfilers by matching taxpayer returns against information provided to IRS by third parties, initiates taxpayer contact, and closes uncontested cases. The criminal investigation function deals with cases involving illegal activities.

The examination, collection, and criminal investigation functions are conducted primarily by IRS district offices. IRS also encourages the district offices to use information gathering projects to identify income nonreporting. The objectives of these projects are to identify potential areas of nonreporting, determine the reason for the nonreporting, and devise the action(s) needed to reduce it.

To help IRS identify tip income nonreporting, the Congress included in TEFRA certain employer reporting requirements in section 314(a). These requirements deal exclusively with the food and beverage industry. As mentioned earlier, this industry represents the largest population of tipped employees.

This report responds to a request from Senator David Pryor to review IRS' overall efforts in addressing tip income nonreporting. Specifically, this report addresses (1) IRS' efforts to identify and reduce tip income nonreporting, including attempts to quantify the severity of the problem, and (2) the impact of TEFRA's reporting requirements on the food and beverage industry and tip income reporting.

Reporting of Tip Income for Tax Purposes

While IRS has long considered tips as taxable income, the reporting of tip income was first addressed in the Social Security Amendments of 1965 (Public Law 89-97) and in Public Law 89-212, also enacted in 1965, which amended the Railroad Act of 1937 and the Railroad Retirement Tax Act. The purpose of these legislative initiatives was to have employees who receive tips report them as taxable income thereby increasing their social security and retirement benefits.

Public Law 89-97 also added Section 6053 to the Internal Revenue Code. This provision addresses the reporting of tip income. Under the provisions of this section, employees who receive any tips must report them to their employers. Tips are defined as wages or compensation to the extent that they are paid in cash,[1] are equal to $20 or more for 1 month, and are received by employees in the course of their employment for any one employer. The tips are considered paid at the time a written statement including such tips is furnished to the employer by the employee, or if no statement is furnished, at the time the employee receives the tips. Employers, in turn, are required to withhold income and social security taxes on reported tips and remit the withheld taxes to IRS.

[1] According to IRS Publication 531: Reporting Income From Tips, cash tips include an amount a customer voluntarily adds to the bill and the employer, in turn, gives that amount to the tipped employee.

Tax Equity and Fiscal Responsibility Act of 1982

Section 314 of TEFRA amended Section 6053 of the Internal Revenue Code by providing for a revised set of tip income reporting requirements for certain large food and beverage establishments.[2] Under TEFRA, these establishments are now required to report tip-related information annually on Form 8027. This information, among other things, is to include the gross receipts of the establishment from food and beverage operations, the amount of aggregate charge receipts showing tips, and reported tip income.

In addition to these reporting requirements, TEFRA required employers to "allocate"[3] tips among their directly tipped employees (which includes waitresses, waiters, and bartenders) under certain conditions. Such an allocation must occur when total tips reported by the employees to the employer are less than 8 percent of an establishment's gross receipts. The employers then have the option of allocating tips to employees on the basis of any of the following methods: (1) employee hours worked, (2) the percentage of gross receipts attributable to an employee, or (3) an agreement between employees and management. TEFRA stipulated, however, that the employer can petition IRS to lower the 8 percent allocation rate to as low as 5 percent if warranted. Employers are required to place the tip allocation on employees' W-2 forms, but must not withhold taxes from the allocation.

Deficit Reduction Act of 1984

Section 1072 of the Deficit Reduction Act of 1984 (Public Law 98-369) provided for technical modifications to the TEFRA tip reporting requirements. The act amended TEFRA by reducing the minimum percentage of gross receipts required to be allocated as tips from 5 percent to 2 percent. The act also made it possible for the majority of employees of an establishment, in addition to employers, to petition the Secretary of Treasury to reduce the tip allocation rate. The Congress believed that these changes were needed because the definition of a large food or beverage establishment was possibly too stringent and employees should also have the opportunity to petition the IRS for a reduction in the tip allocation rate.

[2] If a tipping establishment employed more than 10 full-time equivalent employees on a typical business day during the preceding calendar year, then it must comply with TEFRA's tip reporting requirements.

[3] The allocation is an apportionment (of the amount equal to the difference between 8 percent of gross receipts and reported tips) distributed among directly tipped employees.

Objectives, Scope, and Methodology

Senator David Pryor asked us to review IRS' efforts to improve tip income reporting and the impact of TEFRA's tip reporting requirements on the food and beverage industry and tip income reporting. He specifically asked that we report on

- the initiatives undertaken by IRS to enhance tip income reporting,
- the steps IRS has taken and plans to take to quantify tip income reporting, and
- the effects of TEFRA's tip reporting requirements on the food and beverage industry and the reporting of tip income.

To accomplish the first objective and to determine the scope and extent of IRS' efforts to identify tip income nonreporting before and after TEFRA (fiscal years 1977 to 1985), we performed detailed work at 18 district offices to determine how IRS has identified tip income nonreporting, selected specific tip income nonreporting projects, and implemented the provisions of TEFRA.

To accomplish the second objective of identifying IRS' initiatives to quantify tip income reporting, we reviewed the methodology IRS used to arrive at the 16 percent tip income reporting rate for 1981. We also reviewed IRS' ongoing efforts and discussed future efforts with IRS officials to determine IRS' plans for developing a more precise estimate of tip income reporting.

To address the third objective, we used a mixed data collection approach consisting of a questionnaire and structured interviews. From a universe of 43,881 food and beverage establishments that complied with TEFRA's reporting requirements in 1983, we selected a nationwide stratified sample of 1,102 establishments to receive a questionnaire. We selected the nationwide sample by using standard statistical techniques. We stratified the sample on the basis of establishments' gross receipts because of congressional concerns that TEFRA's reporting requirements may more severely impact on smaller food and beverage establishments than larger ones. We used gross receipts to measure an establishment's size because the figures were readily available, and we obtained general agreement from industry officials that this was a reasonable measurement for our purpose.

We adjusted our sample from 1,102 to 961 establishments because, during our review, 141 establishments had either closed or had been sold. Thus, our national projections on the basis of questionnaire responses reflect the impact of TEFRA upon those ongoing establishments which complied with TEFRA in 1983. Of the 961 establishments in the adjusted sample, 674 (or 70 percent) responded to our questionnaire. These 674 responses project to 27,415 of 43,881 food and beverage establishments. Appendix IV contains additional information on our sampling methodology.

In addition to these employer questionnaires, we also used structured interviews to obtain additional information from 29 employers and 36 tipped employees who were judgmentally selected. We used these structured interviews to obtain opinions on how the new tip reporting requirements affected them. (For tipped employees, we used this approach in lieu of a questionnaire because we were unable to identify a universe of tipped employees. Due to this limitation, we are unable to make nationwide projections on the basis of the results of the employee structured interviews. Thus, the structured interviews do not provide a statistically valid indication of how the tip reporting requirements affected tipped employees in the food and beverage industry.)

In addressing our third objective, we assessed how well IRS implemented the rate reduction provisions contained in TEFRA. To do this we (1) identified and reviewed National Office instructions, as well as examined each district's rate reduction criteria, policies, and procedures; (2) ascertained how consistently each office, within and among the regions, applied its rate reduction policies; (3) determined under what conditions IRS grants a request for a rate reduction; and (4) reviewed rate reduction request case files.

We performed our work at IRS' National Office, 4 of IRS' 7 regional offices, and 18 district offices (see app. II). We selected these locations generally on the basis of documentation received from each of IRS' seven regions that identified the number of initiatives undertaken by the districts to reduce tip income nonreporting. On the basis of this data and input from the food and beverage industry, we selected the four regions and 18 district offices because (1) the Southwest and Western Regions were the most active in initiating projects to improve tip income reporting; (2) the Midwest and North Atlantic Regions represented two of the five less active regions and, in addition, food and beverage industry representatives recommended that we perform work in nonmetropolitan areas such as those found in the Midwest Region so that our effort would represent a cross section of the country; and (3) TEFRA generated information identified the North Atlantic and Western Regions as having the greatest number of establishments with potentially noncompliant tipped employees.

At each IRS location, we (1) identified the objectives, scope, methodology, current status, and success of each region and district's efforts in uncovering nonreported tip income and (2) gathered statistics on individual projects including number of returns examined and additional taxes and penalties assessed. Specifically, we

- interviewed IRS officials involved in tip income reporting including tip project coordinators for each region and officials responsible for individual projects;
- reviewed internal audit reports, project files, rate reduction request case files, program plans including quarterly reports, fiscal year-end status reports, and Audit Information Management System reports; and
- reviewed the National Office's listing of food and beverage establishments having potentially noncompliant tipped employees based on an annual information return (IRS 1983 Form 8027) resulting from TEFRA's reporting requirements.

Our review was conducted from May 1985 through December 1985, and work was performed in accordance with generally accepted government auditing standards.

IRS' Efforts to Address Tip Income Nonreporting

IRS estimated that in calendar year 1981 the nonreporting rate of tip income for tax purposes was about 84 percent—the highest nonreporting rate among all legal source income areas. The results of this nonreporting was estimated at $8.5 billion in unreported tip income with an estimated revenue loss of $2.3 billion.

Currently, each IRS region and district independently decides on the amount of resources and types of detection methods to be used in pursuing nonreported tip income. We found that the regions and districts we visited varied significantly in their pursuit of this nonreported income. Some IRS offices were much more active and successful than others in dealing with this issue. While two of the four regions we visited limited their efforts because of various constraints, the other two were more active in pursuing tip income nonreporting because they developed a strategy to offset these constraints.

IRS needs an overall strategy for addressing tip income nonreporting. Without such a strategy, the potential will be greater for the loss of tax revenue and the inequitable treatment of taxpayers. IRS recognizes that more can be done and, on the basis of TEFRA-generated data, has recently undertaken several initiatives. For example, it provided its regions a list of establishments with potentially noncompliant tipped employees and established a tip document matching program to better identify tip income nonreporting. IRS also is performing a study mandated by TEFRA on tip income reporting which should provide additional insight into the extent and the reason(s) for nonreporting. While these initiatives will not entirely address the issue, the information from these efforts should help IRS formulate an overall strategy for addressing tip income nonreporting.

This chapter identifies and highlights the various initiatives of four IRS regions for pursuing the nonreporting of tip income and their use of TEFRA-generated data, discusses IRS' newly established tip document matching program, and describes the Service's research efforts to quantify the tip income reporting problem.

IRS' Initiatives to Reduce Tip Income Nonreporting Vary Significantly Among IRS District Offices

IRS has not developed an overall strategy for identifying and reducing tip income nonreporting. Therefore, initiatives to improve tip income reporting are usually the results of localized interest and commitment. Also, IRS has not designed an overview and evaluation process to specifically monitor tip income efforts conducted by regional and district offices.

On the basis of our work in 18 district offices within four IRS regions, we found that initiatives to improve tip income reporting varied significantly. The results of their efforts are shown in table 2.1 which highlights tip income reporting initiatives for fiscal years 1977 through 1985.

Table 2.1: Results of Completed Tip Income Nonreporting Projects Conducted by 18 Districts in Four IRS Regions During Fiscal Years 1977 Through 1985

Regions	Number of tip projects	Number of tax returns examined	Amount of additional taxes and penalties assessed	Amount per return
Western (five districts)	292	34,456	$61,077,624	$1,773
Southwest (three districts)	129[a]	6,456	4,884,506	757
Midwest (six districts)	8[b]	647	456,943	706
North Atlantic (four districts)	2[c]	365	522,413	1,431
Total	**431[d]**	**41,924**	**$66,941,486**	

[a]The three districts in the Southwest Region had conducted 130 projects; however, information was not available on the results of 1 of the projects.

[b]The six districts in the Midwest Region had conducted 19 projects; however, information was not available on the results of the other 11 projects.

[c]The four districts in the North Atlantic Region had conducted six projects; however, information was not available on the results of the other four projects.

[d]Most of these projects focused on the food and beverage industry.

As shown in table 2.1, the Western and Southwest Regions were much more active than the North Atlantic and Midwest Regions in conducting projects to identify the nonreporting of tip income in terms of tax returns examined and additional taxes and penalties assessed. According to IRS officials in the North Atlantic and Midwest Regions, their efforts were limited due to the following constraints:

- The inability to readily obtain information that would identify potential tip income nonreporting.
- Higher priority work such as tax shelters limited the degree of resources that could be directed toward tips.

- The dollar yields from tip income projects were not high enough to meet district examination selection criteria dollar yields.

The Western and Southwest Regions encountered similar constraints and work priorities but still were active in pursuing the tip income nonreporting issue. The difference occurred because these two regions developed a strategy that included selection criteria and a computerized system that offset these constraints to the extent that they could actively pursue tip income nonreporting. The computerized system made the pursuit of tip income nonreporting economically feasible because it enabled these regions to process, in a timely manner, large volumes of tip-related information essential for identifying nonreported tip income. The selection criteria allowed the regions to identify establishments with a large number of potentially noncompliant tipped employees, thereby enabling them to better target scarce audit resources.

In 1977, the Western Region developed a computerized system which reconstructs tip income information. The system computes

- the employee's tip income, which should have been reported, on the basis of information derived from a formula;[4]
- the unreported tip income by taking the difference between what should have been reported on the basis of the above-mentioned formula and what was actually reported; and
- additional income and social security taxes and interest owed.

The system also generates various reports and notices which identify tipped employees' assessed tax liabilities.

According to officials in the Western Region, since the system computerized numerous tedious calculations, it enabled districts to examine many more establishments with tipped employees than were possible using manual methods. While all the district officials could not provide specific information on the time saved, some estimated that use of the system has reduced the time expended on tip nonreporting projects by at least 30 percent and in some cases as high as 75 percent. According to these officials, yields from tip nonreporting projects generally equalled or exceeded the yield from examination cases selected by the district's examination selection criteria.

[4]The formula, known as the McQuatter's Formula, reconstructs tip income using a method which incorporates factors such as the average tip per charge 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.

Further, the districts in this region supplemented the computerized system by establishing criteria for selecting establishments with potentially noncompliant tipped employees. Such selection criteria included leads from ongoing corporate and partnership examinations, establishments with a large number of tipped employees, analyses of employers' quarterly tax returns, and establishments that had not been examined for several years. This criteria allowed IRS to target potentially noncompliant tipped employees, thereby enabling them to better use limited resources.

After learning about the positive results the Western Region was experiencing with its computerized tip income system, the Southwest Region also decided to utilize the system to pursue tip income nonreporting and approved a regionwide effort in 1982. According to district officials, their results were similar to those that had been achieved by the Western Region. For example, yields from their tip nonreporting projects also equalled or exceeded the yield of examinations which were selected on the basis of the district's selection criteria. Similar to the Western Region, the districts in the Southwest Region also established criteria for selecting establishments for tip projects. The criteria included an establishment's location, type of clientele, number of employees, leads from corporate examinations, and personal knowledge and experience of revenue agents.

While National Office officials are aware of the approaches used by the Western and Southwest Regions, they have not yet evaluated them for Service-wide applicability. According to National Office officials, they did, however, review the Western Region's tip income approach to determine its use for the nationwide tip study mandated by TEFRA. As a result of this review, they concluded that the Western Region's approach would require a significant amount of staff training to implement and therefore would have prohibited the timely completion of the study. These officials said that IRS plans to broaden its evaluation to determine the Service-wide applicability of this approach as part of its effort to develop an automated examination system. This proposed system is scheduled for implementation in 1989.

Considering the additional revenue generated by the Western and Southwest Regions' tip nonreporting projects and the more efficient use of resources as noted by officials from the two regions, IRS should evaluate the approach for Service-wide use. This evaluation would place IRS in a better position to identify the possible benefits to be gained on a Service-wide level.

In October 1984, IRS headquarters attempted to overcome some of the constraints cited by the North Atlantic and Midwest Regions by providing to the regions TEFRA-generated data from calendar year 1983 Form 8027 which could be used to identify potential tip income nonreporting. However, the data was not used extensively at that time because IRS headquarters also advised the regions and districts not to initiate any tip projects if such an effort would limit the resources needed for the tip study mandated by TEFRA. According to officials in IRS' National Office, the Service plans to continue this effort. In fact, during January 1986, the National Office sent to the regional offices TEFRA-generated tip income information for calendar year 1984. We support the continuation of this effort. Information made possible by TEFRA is an important component in developing an overall approach for addressing tip income nonreporting.

While two of the four IRS regions we visited had a strategy for overcoming the obstacles in the pursuit of nonreported tip income the other two regions did not. Tip income nonreporting efforts of the less active regions were limited and the noncompliant tipped taxpayers in these regions were less likely to be identified. In contrast, in the more active regions, noncompliant tipped taxpayers had a greater chance of being identified and pursued. In the absence of a more coordinated approach, the potential for the loss of revenues from nonreported tip income and the inequitable treatment of tipped taxpayers will be greater.

IRS' Document Matching Program for Tip Income

Although IRS districts were not extensively using TEFRA's information in their tip efforts, the National Office has begun incorporating such information into its ongoing Information Returns Program (IRP)—a computerized program where third-party information is matched with the income reported on individual tax returns. IRS uses this program to identify situations of potential unreported income and/or nonfiling of tax returns.

As previously mentioned, TEFRA requires an employer to allocate tips among directly tipped employees when total tips reported by employees to the employer do not equal at least 8 percent of gross receipts. The difference between the 8 percent of gross receipts and what was reported as tip income by the employees to the employer is then allocated among directly tipped employees. The employer, in turn, is required to record this allocation on each employee's W-2 form and forward it to IRS. In 1985, the IRP program began matching allocated tip income and wages reported on the W-2's with income reported on individual tax returns.

After the matching process is completed, follow-up work is to be conducted by IRS' 10 service centers. If the results of the matching process show a difference between the amount on the W-2 form and the amount of wages declared on the individual tax return, service centers are to mail notices to taxpayers requesting documentation to substantiate the correct amount. If taxpayers fail to submit acceptable and adequate documentation, the allocated tips are to be considered correct and are to be used to make tax adjustments.

This document match program should be an excellent tool for detecting those individual taxpayers who received an allocation but did not include it on their tax returns. However, this system does not include those tipped employees who did not receive an allocation but may have underreported their tip income. Even so, this program, coupled with a more active regional/district effort, should enhance IRS' overall efforts in reducing the nonreporting of tip income.

IRS' Efforts to Quantify Tip Income Nonreporting

For a number of years, IRS has been doing research to better quantify tip income reporting. During congressional hearings on TEFRA, IRS testified that the reporting rate for tip income was estimated to be 16 percent in calendar year 1981. To arrive at this estimate, IRS used Bureau of Economic Analysis in-house estimates of tip income and Social Security Administration information on tips in connection with social security taxes. IRS officials stated that the 16 percent rate was the most reasonable estimate based on available information at the time. They also said that with new information provided under TEFRA's provisions and additional tip compliance studies, a more precise estimate can be developed.

To develop a better estimate, IRS contracted with the Survey Research Laboratory of the University of Illinois to conduct research on estimating tip earnings. The study's approach is to interview the consumer. The data will be based on a national consumer panel composed of 12,800 households whose members are required to maintain a diary of all tipping occasions. According to IRS documents, the data will be used to help construct a table of tipping rates by industry, occupation, geographical distribution, and any other criteria which are found to be material. The most recent information derived from this research effort showed that tipping by American households totalled at least $9.5 billion in 1984 and tip rates, tips as a percentage of individual expenditures on all occasions (including nontipping occasions), were 12.1 for eating places, 9.5 for barber and beauty shops, 17.9 for taxi service, and 15.3 for bars and drinking places.

An additional effort to better understand and quantify tip income reporting is mandated by TEFRA. TEFRA requires the Secretary of the Treasury to conduct a compliance study for the tipping industry (food and beverage) and prepare a report for the Congress. The legislation mandates that the study include an analysis of tipping patterns, tip-sharing arrangements, and tip compliance patterns. According to an IRS official, fieldwork began in November 1985 and is expected to be completed in April 1987, and the report is scheduled to be issued in December 1987.

According to an IRS official, it is expected that the resulting report will contain recommendations to the Congress and/or IRS on possible changes needed to improve IRS' tip income reporting activities. The combination of this study and the research effort by the University of Illinois should provide IRS with more information to better address the issue.

Conclusions

IRS estimated that in 1981, the rate of tip income reporting was the lowest among all legal source income categories. Efforts to identify and reduce this nonreporting, however, have been limited and fragmented. Each IRS region and district independently decides on the amount of resources and types of audit techniques used to address this issue. Of the four regions we visited, two were more active in pursuing the issue than the other two. The constraints cited by the two less active regions for their limited effort seemed to have been overcome by the other two regions. These regions were able to devise a strategy which included selection criteria and a computerized system, which allowed them to make inroads into reducing tip income nonreporting.

While IRS National Office officials are aware of these approaches, they said that they have not yet evaluated them for Service-wide applicability. Considering the additional revenue generated by the Western and Southwest Regions, and the more efficient use of resources as noted by officials from these regions, the National Office should determine the Service-wide applicability of the approaches. National Office officials said IRS does plan to evaluate the Western Region's approach for Service-wide use as part of its effort to develop an automated examination system which is scheduled to be implemented in 1989. This evaluation would place IRS in a position to identify the possible benefits to be gained on a Service-wide level.

IRS should formulate an overall strategy and monitoring system for addressing the nonreporting of tip income on a Service-wide basis.

TEFRA's mandated tip study scheduled to be completed in December 1987 should provide IRS with the information needed to develop this strategy. This study, coupled with the document matching program for tip income, information now available because of TEFRA's reporting requirements, and experience gained from the Western and Southwest Regions' tip income reporting work, places IRS in a good position to comprehensively address the issue. Without such a strategy, the potential will be greater for the loss of tax revenue and inequitable treatment of taxpayers.

Recommendation

To enhance the Service's efforts to improve compliance with the requirements for reporting tip income, we recommend that the Commissioner of Internal Revenue formulate and implement an overall strategy for identifying and reducing tip income nonreporting. In formulating this strategy, the Commissioner should, in conjunction with providing TEFRA tip income information to the regional and district offices,

- identify and evaluate for Service-wide applicability those detection techniques and tools which have been proven effective in conducting tip income reporting projects and communicate this information to all IRS regions and districts and
- design and implement an overview and evaluation process to monitor the progress of tip enforcement activities, identify potential problem areas, and devise the action(s) needed to deal with them.

Agency Comments and Our Evaluation

The Acting Commissioner of Internal Revenue, in commenting on a draft of this report (see app. V), agreed with the general thrust of the report. He also highlighted various activities that the Service has underway which will aid in formulating and implementing an overall strategy for identifying and reducing tip income nonreporting. These activities include (1) performing a congressionally mandated study which will provide information on levels of tip nonreporting and the types of establishments and geographical areas where potentially noncompliant tipped employees work; (2) communicating to all IRS regions detection techniques and tools which have been proven effective in reducing tip income nonreporting; (3) identifying, through the use of TEFRA-generated data, those establishments which employ potentially noncompliant tipped employees and providing this data to IRS' regions and districts for follow-up consideration; and (4) identifying tip income projects being conducted throughout the system and comparing them on a national, regional, and district basis.

TEFRA's Impact on the Food and Beverage Industry

Most of the food and beverage establishments responding to our questionnaire indicated that implementing TEFRA's reporting requirements has not been as costly as originally envisioned. Our data also shows that the amount of additional tip income reported by the employers to IRS has increased since TEFRA's implementation. Further, employees in the food and beverage industry expressed mixed views about TEFRA's impact on them.

We also obtained data on IRS' process for administering TEFRA's provision which permits employers to petition IRS for a reduction from the reporting of 8 percent of gross receipts as tip income. Based on this data, we found that IRS' district offices in the four regions were using different criteria when assessing the merits of these requests. Under the current process, the subjectivity and varying methods for evaluating rate reduction requests may result in different decisions being reached for similar requests.

Administrative Costs Associated With Implementing TEFRA

Certain industry segments had projected that the average food and beverage establishment would spend approximately $6,000 in calendar year 1983 in order to comply with TEFRA; however, our survey shows the actual cost to have been substantially lower for most of our sample. Based on the responses to our questionnaire, we project that out of a universe of 27,415 food and beverage establishments, at least 21,604 experienced an initial cost to comply with TEFRA and, of these, 14,664, or about 68 percent, had an initial cost of $2,000 or less. Further, we project that out of the universe of 27,415 establishments, at least 21,483 have experienced recurring cost and 15,065, or about 70 percent, of these establishments are experiencing annual costs of $2,000 or less.

Cost of Complying With TEFRA

Due to congressional concerns indicating that TEFRA's requirements might have a more severe impact on smaller establishments than upon larger ones, we stratified our questionnaire sample on the basis of gross receipts as reported to IRS for calendar year 1983. We used gross receipts to measure an establishment's size because the figures were readily available, and we obtained general agreement from industry officials that this was a reasonable measurement for our purposes. Table 3.1 shows by gross receipts the initial cost incurred by various size companies to implement TEFRA's tip provisions.

Table 3.1: Food and Beverage Establishments' Initial Cost of Implementing TEFRA's Reporting Requirements

	Establishment size by gross receipts							
Start-up cost	**$1 to $49,999**	**$50,000 to $99,999**	**$100,000 to $249,999**	**$250,000 to $499,999**	**$500,000 to $999,999**	**$1,000,000 to $9,999,999**	**$10,000,000 and over**	**Total establish-ments**
$1-$500	493	421	1,820	2,649	1,593	680	1	7,657
$501-$1,000	79	211	832	866	1,003	204	1	3,196
$1,001-$1,500	64	79	468	408	472	510	4	2,005
$1,501-$2,000	95	184	364	255	531	374	3	1,806
over $2,000	127	105	728	815	826	1,021	4	3,626
Cannot estimate	222	237	676	917	885	374	3	3,314
Subtotal	1,080	1,237	4,888	5,910	5,310	3,163	16	21,604
No cost	32	26	0	0	177	0	0	235
Total	**1,112**	**1,263**	**4,888**	**5,910**	**5,487**	**3,163**	**16**	**21,839**[a]

[a]The difference between this total and the universe of 27,415 represents those establishments which did not respond to questions regarding cost and those establishments for which we were unable to determine their gross receipts.

As table 3.1 indicates, the cost most frequently given for complying with TEFRA ranged from $1 to $500. Also, as mentioned previously, we project that about 68 percent (14,664/21,604 = 68 percent) of the establishments that incurred initial cost had a cost of $2,000 or less to implement TEFRA, which is significantly below the $6,000 cost initially estimated by the food and beverage industry. Table 3.2 shows the nature of the expenditures for which the establishments had incurred the additional cost.

Table 3.2: Type of Cost Incurred by Food and Beverage Establishments to Implement TEFRA[a]

	Establishment size by gross receipts							
Type of cost	**$ 1 to $49,999**	**$50,000 to $99,999**	**$100,000 to $249,999**	**$250,000 to $499,999**	**$500,000 to $999,999**	**$1,000,000 to $9,999,999**	**$10,000,000 and over**	**Total**
Overtime	620	474	2,184	2,700	2,773	1,667	11	10,429
Use of consultants	461	579	2,496	3,668	2,360	1,463	4	11,031
Hired additional employees	127	342	572	1,477	1,416	884	3	4,821
Purchased computer software	667	579	2,755	2,343	2,006	1,871	11	10,232
Purchased computer	32	53	416	917	531	306	0	2,255
Other	143	132	520	1,172	944	204	0	3,115

[a]Because some establishments incurred more than one type of cost, the totals in this table do not agree with the totals in table 3.1.

Our analysis of establishments' responses shows that some establishments incurred more than one type of cost to comply with TEFRA's reporting requirements. As table 3.2 shows, the most commonly incurred cost items for all size companies were overtime, use of consultants, and the purchase of computer software. The item cited the least for incurred cost was the purchase of a computer.

Further analysis of our questionnaire responses shows that in addition to initial implementation cost, food and beverage establishments also incurred recurring cost associated with TEFRA's reporting requirements. Table 3.3 shows the recurring cost categorized by various size food and beverage establishments.

Table 3.3: Annual Recurring Cost Encountered by Food and Beverage Establishments in Complying With TEFRA's Reporting Requirements

	Establishment size by gross receipts							
Recurring cost	**$1 to $49,999**	**$50,000 to $99,999**	**$100,000 to $249,999**	**$250,000 to $499,999**	**$500,000 to $999,999**	**$1,000,000 to $9,999,999**	**$10,000,000 and over**	**Total**
$1-500	302	606	2,184	2,445	1,652	646	1	7,836
$501-$1,000	318	237	936	611	944	578	9	3,633
$1,001-$1,500	48	53	260	560	590	306	2	1,819
$1,501-$2,000	64	105	312	306	649	340	1	1,777
over $2,000	95	105	468	408	531	918	2	2,527
Cannot estimate	254	105	676	1,375	1,003	476	2	3,891
Subtotal	1,081	1,211	4,836	5,705	5,369	3,264	17	21,483
No cost	32	53	104	204	118	34	0	545
Total	**1,113**	**1,264**	**4,940**	**5,909**	**5,487**	**3,298**	**17**	**22,028[a]**

[a]The difference between this total and the universe of 27,415 represents those establishments which did not respond to questions regarding cost and those establishments for which we were unable to determine their gross receipts.

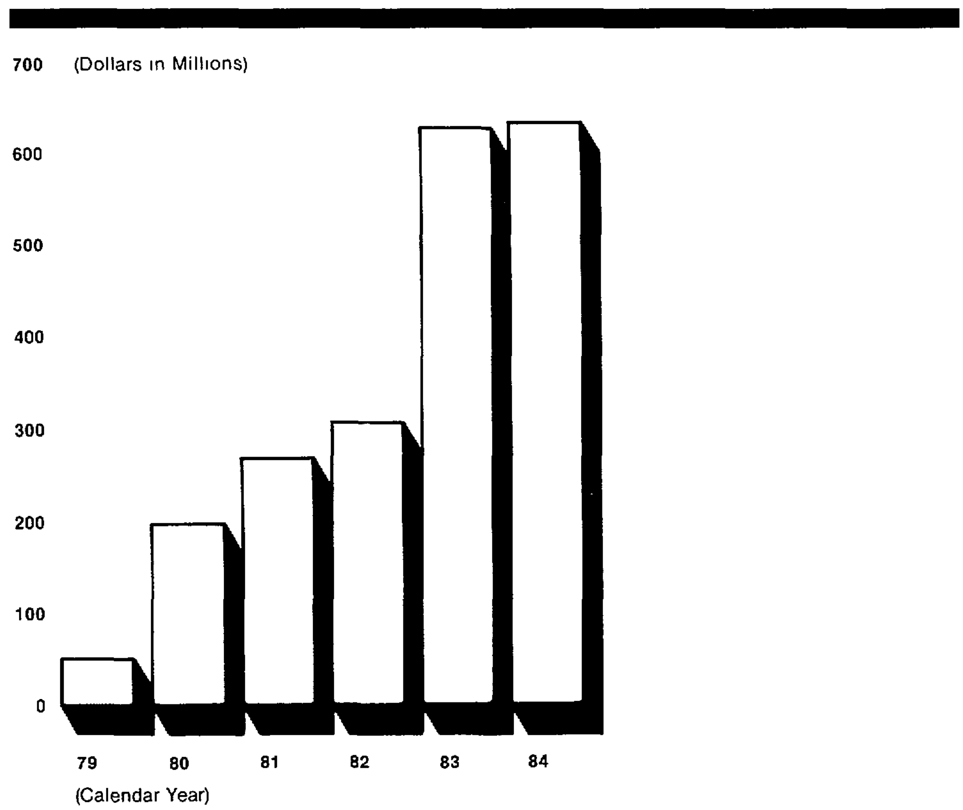
We project that for most establishments experiencing recurring cost, (15,065/21,483 = 70 percent) that cost is $2,000 or less. Of these, the most frequently cited range of recurring cost in our questionnaire responses was $1 to $500.

TEFRA's Impact on Tip Income Reporting

The tip income reporting requirements mandated by TEFRA appear to have resulted in an increase in tip income reporting. This was evidenced by our analysis of tip income information reported to IRS on Form 941 by the employers who owned the establishments in our sample and by the responses to our questionnaire. Form 941 is the quarterly federal tax return employers use to report the withholding of income and social security taxes. Line 7a of the form is used to report the amount of tip income reported to employers by employees.

As illustrated in figure 3.1, our analysis of the tip income information submitted to IRS on Form 941 by the 600 employers who owned the 1,102 establishments in our sample showed that reported tip income in their establishments increased from about $300 million in calendar year 1982 to over $600 million in calendar year 1983. It should be noted that these employers also owned other establishments besides those included in our sample. Because the tip income information reported by employers on Form 941 is consolidated and does not identify each establishment of an employer, our analysis had to include all establishments owned by these employers—not just the establishments in our sample.

Figure 3.1: Tips Reported by Employees to the Employers in GAO's Questionnaire Sample



In addition, we project from our questionnaire responses that out of a projected universe of 20,084 food and beverage establishments, at least 16,280 (81 percent) would attribute, to some extent, the increase in tip income reporting to TEFRA. Although we cannot attribute all of the increase in reported tip income to TEFRA, it appears that TEFRA did promote better tip income reporting. According to IRS, TEFRA increased tip income reporting by 108 percent on an annual basis between 1982 and 1983, representing an additional $1 billion in reported tip income for 1983.

Views of Certain Food and Beverage Employees About TEFRA's Impact on Them

During the course of our work, we judgmentally selected and interviewed 36 employees from 29 establishments. Although those interviewed had various concerns pertaining to TEFRA's requirements, the concerns most frequently raised centered around the unfairness they believed was associated with (1) the fact that TEFRA's provisions do not pertain to indirectly tipped employees (busboys, service bartenders) and (2) the allocation of tip income among directly tipped employees on the basis of hours worked.

A number of directly tipped employees stated that TEFRA's requirements discriminated against them since other types of tipped employees did not receive tip allocations. They stated that indirectly tipped employees rarely report tips which they receive from directly tipped employees thereby, in some instances, requiring employers to allocate tips among the directly tipped employees. As discussed earlier, the allocation process occurs when total tips reported by employees to their employers do not represent 8 percent of gross receipts. Consequently, if indirectly tipped employees failed to report all of their tips, the total tips reported might be less than 8 percent of gross receipts. This would require the employer to allocate the difference among directly tipped employees.

Some employees also stated that employers' use of employee hours worked as the basis for allocating tips leads to inequities in the amount of tip income allocated. As previously mentioned, when allocating tips, an employer has the option of either basing the allocation on employee hours worked or the percentage of gross receipts attributable to an employee. In reference to the "hours worked" method, most complaints came from those employees who worked day rather than night shifts. They stated that allocating tips based on hours worked leads to undue tip income allocations for day employees who work the same number of hours as evening employees but receive less tip income.

We do not know the frequency with which such situations may occur. However, even in such situations, no taxes would be withheld on allocated tips. Furthermore, if the employee could substantiate with adequate records that the allocated tip income was not earned, then it would not be considered as taxable income.

IRS' Administration of the Rate Reduction Process Varies

Our audit work at 18 district offices within four IRS regions showed that IRS needs to improve its administration of TEFRA's provision which permits employers to petition IRS for a reduction from the reporting of 8 percent of gross receipts as tip income. The various methods used by IRS districts to review the merits of a rate reduction request were different and could result in inequitable treatment of tipped employees working for establishments applying for rate reductions. Although we recognize that total consistency is impossible, we believe that IRS can improve the situation.

When the Congress passed TEFRA's tip provisions, certain safeguards were included with the intent that the provisions would not adversely affect employees of food and beverage establishments. One such safeguard permits employers to petition IRS for a reduction from the reporting of 8 percent of gross sales as tip income provided the employer can justify a lower rate. The Commissioner of IRS delegated the responsibility for granting rate reductions to the directors of IRS district offices.

Although the National Office's guidelines for implementing TEFRA's rate reduction provisions outline the documentation needed to accompany a rate reduction request, they do not contain procedures on how the data should be analyzed. The National Office guidelines, formalized into Revenue Procedure 85-4, stated that a request should include such information as an establishment's gross receipts, location, and type of clientele. However, the National Office did not provide accompanying instructions to field officials on how to evaluate the data when making decisions on rate reduction requests. In addition, IRS did not establish a monitoring process to identify how each district implemented this review process. As a result, IRS is not in a good position to identify problem areas and the action(s) needed to correct them. We found that various methods of evaluation were being used by the four regions we visited.

North Atlantic Region

Three of the four districts we visited in the North Atlantic Region—Boston, Buffalo, and Manhattan—prepared standard letters to request from employers the information outlined in the general guidelines provided by headquarters. Albany based its determination on the initial information submitted by employers. Once the necessary information was obtained, districts had to evaluate the facts, evidence, and circumstances to determine whether a lower rate was justified. IRS district agents told us that the National Office instructions had provided no guidance on the circumstances, conditions, or reasons that could warrant a lower rate. They also said that the process was subjective since most of the establishments requesting a rate reduction did not accept credit cards upon which a tip rate could be determined and there were no written records of tips earned. Even with the information establishments were asked to provide, agents said they could not evaluate the validity of tip rates at cash-only establishments. They had to use less objective factors, such as location and types of customers served, to evaluate an establishment's tipping rate.

As a consequence, determinations in these districts were based primarily on the reviewing official's familiarity with an establishment's operations. Thus, some officials believed that different conclusions could be reached based on the same information.

Western Region

The five districts we visited in the Western Region required an employer to complete a questionnaire and submit certain documents or information as outlined by the general instructions provided by IRS headquarters. In four of the five districts, a revenue agent sometimes visited an establishment before deciding to grant or deny a request.

In arriving at a decision, each district applied different standards. The Los Angeles District required a completed questionnaire and a field visit to each establishment during which the IRS agent was to review sales records and payroll registers, sample charge sales receipts, and interview employees and employers. The agent usually noted the restaurant's quality, size, location, and type of clientele and their tipping practices. To varying degrees, the Seattle, Honolulu, and Las Vegas Districts followed similar procedures. Unlike the other four districts, San Francisco did not make field visits. Instead, the district's decision was based primarily on information submitted by the employer.

Officials in all five districts had no specific criteria on which to base their decisions on rate reduction requests. For example, one district official told us that some decisions were based on an "educated guess" of the tipping rate. Another official said that decisions generally involved a "judgment call" as to whether information submitted by the employer should be accepted at face value.

Midwest Region

Our visits to six districts within the Midwest Region also disclosed various approaches used in making rate reduction request decisions. Approaches differed regarding the information each district required from the requester and the methodology for reviewing applications.

With the exception of Helena, all of the districts requested additional information beyond that included in Revenue Procedure 85-4. This additional information ranged from establishments' type of entertainment to the hourly wage rates for employees. While the St. Paul and Fargo Districts placed heavy emphasis on information regarding the charged tip rate, the Omaha, Chicago, and St. Louis Districts did not request such information. In contrast, Chicago and St. Paul were the only districts that requested information on the use of tips to meet the minimum wage requirements.

The districts not only required different information but also assessed it differently when determining whether to grant a rate reduction. In the Helena and Omaha Districts, the decision on whether to grant a rate reduction was based on a reviewer's judgment of the data submitted with each rate reduction request. In contrast, St. Paul and Chicago District officials based their decision on multiple reviews and generally required a consensus before approving or rejecting a rate reduction request. Conversely, the St. Louis District used a weighted point system to evaluate each component of supporting documentation in a rate reduction request. The system was developed by the Southwest Region and is discussed in the following section.

Southwest Region

The Southwest Region developed a rate reduction implementation package which it distributed to its districts in June 1983. According to regional officials, the package was developed to provide a consistent approach and to reduce the subjectivity in the rate reduction process. Two of the three IRS districts we visited were using the region's rate reduction approach. However, officials in the other district told us they supplemented the regional approach to meet the district's needs.

The regional package consisted of form letters for corresponding with taxpayers and instructions for making rate reduction determinations. This region primarily used a weighted point system for considering the information when reviewing requests. Weights were assigned to factors such as type of operation, alcoholic beverages as a percent of sales, type of clientele, sales volume, and menu pricing. The revenue agent reviewing the rate reduction request assigned a weighted value to the factors of an establishment and the weights were added to arrive at a total point value for an establishment. The total point value was then compared to a chart which listed total point ranges and corresponding tip rates. On the basis of this, a request for relief from the reporting of 8 percent of gross sales as tip income was either granted or denied.

Of the three IRS districts we visited in the Southwest Region—Albuquerque, Dallas, and Denver—we found that Albuquerque and Dallas for the most part followed the region's approach. An Albuquerque official stated that he strongly supported the approach because he felt that it assured consistent and objective treatment of all requesters. A Dallas District official who reviewed rate reduction requests stated that it was the district's policy to use the region's approach as a guideline.

Conversely, a Denver District official stated that the Southwest Region's package is only one of several factors used to determine rate reductions in this district. According to the official, the district also used the reviewer's knowledge of the establishment, specific case information requested by the district (e.g. charged tip rate), and the University of Illinois Consumer Tipping Study. Further, another district official stated that the point value approach does not consider all factors such as the average tip per charged receipts, wages paid to employees, or employee turnover. Thus, the district supplements the regional package with additional information.

Even though the Southwest Region was the only one of the four IRS Regions we visited that attempted to develop a uniform rate reduction process, we found that this region's process was being applied differently by one of the three districts we visited. Therefore, as in the other three IRS regions, the potential for the inconsistent treatment of taxpayers existed within the Southwest Region.

Conclusions

It appears that food and beverage establishments regardless of their size have not incurred the cost to implement TEFRA that some industry representatives originally envisioned. Our questionnaire responses indicate that about 68 percent of a projected 21,604 establishments which incurred initial cost in complying with TEFRA experienced a cost of

$2,000 or less and about 70 percent of 21,483 establishments experienced an annual recurring cost of $2,000 or less. Certain industry segments had projected that the average establishment would spend approximately $6,000 in 1983 to comply with TEFRA.

The tip income reporting requirements mandated by TEFRA appear to have resulted in an increase in tip income reporting. Our analysis of tip income information reported to IRS by the employers in our questionnaire sample showed that tip income had increased from about $300 million in calendar year 1982 to over $600 million in calendar year 1983. In addition, we project from our questionnaire data that out of a universe of 20,084 food and beverage establishments, at least 16,280 (81 percent) establishments would attribute the increase in the reporting of tip income to some extent to TEFRA.

An analysis of IRS' process for reviewing employers' requests for a reduction from the mandatory reporting of 8 percent of gross receipts as tip income shows that improvements are needed. Currently, IRS district offices are using various approaches when determining if an employer's rate reduction request is warranted. Therefore, the rate reduction process used by IRS regions and districts we visited is not uniform and creates a situation that can promote unintended inequitable treatment of taxpayers. Further, IRS does not have a process to monitor how district offices are implementing the rate reduction review process. Although it is not possible to eliminate all of the subjectivity from the rate reduction process, more standardized instructions on how to analyze the information and more oversight would provide better assurance of a more consistent Service-wide approach.

Recommendation

To reduce the inconsistencies in the rate reduction process, we recommend that the Commissioner of Internal Revenue (1) establish uniform criteria and standard procedures for reviewing employers' requests for a reduction from the reporting of 8 percent of gross receipts as tip income and (2) monitor the implementation of the review process to assure a reasonably consistent Service-wide approach.

Agency Comments and Our Evaluation

In responding to a draft of our report, IRS commented that while it will issue instructions on how the information contained in a rate reduction request is to be evaluated, this is a subjective area that does not lend itself to uniform criteria. IRS also said that it will require the regions to more closely monitor the process to ensure consistent treatment of applicants.

We agree that it is not possible to eliminate all of the subjectivity from the rate reduction process and made that point in our conclusions. The thrust of our recommendation was to reduce the amount of subjectivity that presently exists. We used the phrase "uniform criteria" in our recommendation to emphasize to IRS the need to eliminate as much subjectivity as possible. IRS' action is responsive to the thrust of our recommendation.

Request Letter

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COMMITTEES:
AGRICULTURE, NUTRITION, AND FORESTRY
FINANCE
SPECIAL COMMITTEE ON AGING
SELECT COMMITTEE ON ETHICS

August 27, 1984

The Honorable Charles A. Bowsher
Comptroller General of the United States
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Bowsher:

During Congressional consideration of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), there was considerable debate about the provisions relating to tip income. There were allegations of substantial noncompliance with income tax provisions, but questions were raised about the validity of data used in support of these allegations.

Nevertheless, the 1982 Act authorized IRS to impose additional reporting requirements on owners of certain food and beverage establishments that employ individuals who receive tips. Those employers are now required to make paper allocations of tip income to their tipped employees so that the total amount of tips reported on informational returns to IRS equals or exceeds 8 percent of the gross receipts of the establishment.

I would request that GAO examine the implementation of TEFRA's new tip reporting requirements and report on

--efforts to quantify the tip income noncompliance problem,

--major problems IRS encounters in dealing with tip nonreporting,

--types of problems employers and their employees in the food and beverage industry have with the new reporting requirements,

--success of the new reporting requirements in promoting better compliance.

I am concerned about noncompliance, but I am also concerned about the burden TEFRA's new reporting requirements may be placing on food and beverage employers in terms of requirements for record-keeping, reporting, and allocation of income. I would like a report

Mr. Bowsher
Page Two

on the status of implementation of the 1982 provisions and any suggestions you may have about alternative or supplemental procedures to address this matter in a way that minimizes the burden on all parties involved.

I appreciate your consideration in regard to this matter.

Sincerely,

David Pryor

Field Locations

In addition to IRS' National Office in Washington, D.C., we performed work at the following locations:

IRS Regional Offices	IRS District Offices
Midwest Region (Chicago, IL)	Chicago, IL
	Fargo, ND
	Helena, MT
	Omaha, NE
	St. Louis, MO
	St. Paul, MN
North Atlantic Region (New York, NY)	Albany, NY
	Boston, MA
	Buffalo, NY
	Manhattan, NY
Southwest Region (Dallas, TX)	Albuquerque, NM
	Dallas, TX
	Denver, CO
Western Region (San Francisco, CA)	Honolulu, HI
	Las Vegas, NV
	Los Angeles, CA
	San Francisco, CA
	Seattle, WA

Summary of Responses by the Food and Beverage Industry on the Impact of TEFRA's Tip Income Reporting Requirements

SURVEY OF THE INTERNAL REVENUE SERVICE'S
REPORTING REQUIREMENTS ON THE
FOOD AND BEVERAGE INDUSTRY

INTRODUCTION

The U.S. General Accounting Office (GAO), an agency of the Congress, is evaluating the Internal Revenue Service's (IRS') operations concerning tip income. The GAO is not a part of any other federal agency, including IRS. The purpose of this questionnaire is to obtain information in order to respond to a congressional request for GAO to determine the effects IRS' 1983 tip income reporting requirements have had upon (1) the food and beverage industry and (2) tip income reporting. Your response will help us reply to the congressional request.

The questionnaire is meant to be answered by an individual(s) familiar with IRS' Form 8027 and related instructions which cover tip income reporting requirements. When we refer to your "establishment", we mean only that particular establishment whose name and address appear on the cover letter.

Throughout this questionnaire there are numbers printed within parentheses to assist our keypunchers in keying responses for computer analysis. Please disregard these numbers.

Your responses will be treated confidentially. Responses of individuals will not be made available to any other agency. They will be combined with others and reported only in summary form to the Congress. The questionnaire is numbered only to aid us in our followup efforts and will not be used to identify you with your response. After the questionnaires have been processed, the link between your establishment and your responses will be destroyed and no one will be able to tell how you or any other establishments answered.

The questionnaire can be completed in about 15 minutes. Most of the questions can be easily answered by checking boxes or filling in blanks. Space has been provided for any additional comments at the end of the questionnaire. If necessary, additional pages may be attached.

Please return the completed questionnaire in the enclosed self-addressed envelope within 10 days. In the event that the envelope is misplaced, please mail the completed questionnaire to:

Ms. Lucy Hall
U.S. General Accounting Office
Room 3858
441 G Street, N.W.
Washington, D.C. 20548

If you anticipate any difficulty in returning the questionnaire promptly or if you have any questions, you may call Mr. Ron Berteotti or Ms. Lucy Hall on (202) 566-6503.

Thank you for your cooperation.

A. BACKGROUND

1. About how long have you owned or been employed by this establishment? (CHECK ONE BOX.) (6)

   1. [13] Less than 6 months
   2. [16] From 6 months to less than 1 year
   3. [33] From 1 year to less than 2 years
   4. [63] From 2 years to less than 3 years
   5. [520] 3 years or more

(IF YOU ARE THE OWNER, PLEASE SKIP TO QUESTION 3.)

2. About how long have you been in your present position? (CHECK ONE BOX.) (7)

   1. [22] Less than 6 months
   2. [25] From 6 months to less than 1 year
   3. [54] From 1 year to less than 2 years
   4. [47] From 2 years to less than 3 years
   5. [339] 3 years or more

3. Is this establishment a franchise? (CHECK ONE BOX.) (8)

   1. [113] Yes
   2. [549] No

4. Which of the following types of ownership best represents your establishment's ownership? (CHECK ONE BOX.) (9)

   1. [39] Individual proprietorship
   2. [66] Partnership
   3. [545] Corporation
   4. [19] Other, please specify________

5. We know the number of employees may vary during the year. However, in an average business week, how many total, full-time, and part-time (less than 35 hours per week) employees does your establishment employ? (ENTER NUMBERS.)

   1. 92 (mean)[a] Total employees (10-13)
   2. 52 (mean) Full-time employees (14-17)
   3. 40 (mean) Part-time employees (18-21)

6. Of the total employees, how many employees are (1) directly tipped and (2) indirectly tipped, such as service bartenders, etc. (ENTER NUMBERS.)

   1. 47 (mean) Directly tipped employees (22-25)
   2. 13 (mean) Indirectly tipped employees (26-29)

[a]Notation of the word mean indicates that the sum of all individual responses was divided by the total number of respondents answering the question. This is often referred to as the "average."

7. Which of the following best describes your type of food/beverage establishment? (CHECK ONE BOX.)
(30)

1. [591] Restaurant (full or limited menu provided, with or without liquor)

2. [16] Coffee/donut/pastry/ice cream shop or lunch counter

3. [35] Bar, tavern, nightclub, or other drinking place

4. [28] Other, please explain ____

8. About how much is the average bill per person at this establishment at lunch-time and at dinner-time? (CHECK ONE BOX FOR LUNCH-TIME AND ONE BOX FOR DINNER-TIME.)

	Lunch-time (31)	Dinner-time (32)
1. $5.00 or less	[362]	[132]
2. $5.01 - $10.00	[218]	[245]
3. $10.01 - $15.00	[20]	[152]
4. $15.01 - $20.00	[9]	[49]
5. $20.01 - $25.00	[3]	[23]
6. $25.01 - $30.00	[ ]	[10]
7. Over $30.00	[1]	[8]

B. IRS' TIP REPORTING REGULATIONS

9. How much of a problem, if any, was it to determine whether this establishment must comply with the IRS' 1983 additional tip reporting requirements (that is, that there are more than 10 full-time equivalent employees)? (CHECK ONE BOX.)
(33)

1. [45] Very great problem

2. [40] Great problem

3. [125] Moderate problem

4. [52] Some problem

5. [379] Little or no problem

- - - - - - - - - - - - - - - -

6. [32] No basis to judge

10. Overall, how easy or difficult is it to understand the IRS instructions on how to comply with tip income reporting, including completing IRS Form 8027, "Employer's Annual Information Return of Tips Income and Allocated Tips"? (CHECK ONE BOX.)
(34)

1. [15] Very easy

2. [112] Easy

3. [204] Neither easy nor difficult

4. [229] Difficult

5. [109] Very difficult

11. In late 1983, according to IRS, they mailed Publication 1215, Information on Tip Reporting and Allocation to a large number of food and beverage establishments. Did this establishment receive or obtain a copy of the Publication from either IRS or another source? (CHECK ONE BOX.)

(35)

1. [244] Yes, from IRS
2. [147] Yes, from another/unknown source
3. [100] No } (SKIP TO Q. 13)
4. [170] Don't know } (SKIP TO Q. 13)

12. How helpful or not was Publication 1215 in explaining the new law? (CHECK ONE BOX.)

(36)

1. [4] Very great help
2. [85] Great help
3. [154] Moderate help
4. [116] Some help
5. [26] Litte or no help

13. How much of a problem, if any, is the IRS requirement to separate total charged receipts with tips from total gross receipts? (CHECK ONE BOX.)

(37)

1. [179] Very great problem
2. [103] Great problem
3. [136] Moderate problem
4. [51] Some problem
5. [86] Litte or no problem

- - - - - - - - - - - - - - -

6. [113] No basis to judge

14. IRS now uses 8 percent of gross receipts as a minimum reporting requirement. In your opinion, in this establishment, is this estimate of tips received high, low, or about what tipped employees receive? (CHECK ONE BOX.)

(38)

1. [82] Much too high
2. [141] Too high
3. [245] About what is received
4. [95] Too low
5. [6] Much too low

- - - - - - - - - - - - - - -

6. [102] Don't know .

C. COST TO COMPLY WITH REGULATIONS

15. Did/does your establishment incur any additional start up or recurring cost, (such as overtime cost, hiring new employees, or purchasing computer services) in order to comply with IRS' new tip reporting regulations? (CHECK ONE BOX.)

(39)

1. [552] Yes
2. [103] No } (SKIP TO Q. 21)
3. [18] Don't know } (SKIP TO Q. 21)

16. Which of the following generates the additional cost incurred to comply with IRS' new tip reporting regulations? (CHECK ALL THAT APPLY.)

1. [262] Overtime (40)
2. [26] Extended use of outside consultants (CPA's, lawyers, accountants, and computer firms) (41)
3. [120] Hired additional employees (clerks, accountants, and managers) (42)
4. [270] Purchased computer software and/or revised present software (43)
5. [50] Purchased computer equipment (44)
6. [71] Other, please specify (45)

17. Estimate your 1983 cost (start-up cost) incurred in order to comply with the new tip reporting regulations. (CHECK ONE BOX.)

(46)

1. [6] No cost
2. [186] $1 - $500
3. [71] $501 - $1,000
4. [52] $1,001 - $1,500
5. [49] $1,501 - $2,000
6. [91] Over $2,000 (please specify) $______

- - - - - - - - - - - - - - -

7. [88] Cannot estimate

18. Estimate your establishment's annually recurring additional cost in order to comply with the new tip reporting requirements. (CHECK ONE BOX.)

(47)

1. [13] No cost
2. [186] $1 - $500
3. [103] $501 - $1,000
4. [42] $1,001 - $1,500
5. [42] $1,501 - $2,000
6. [65] Over $2,000 (please specify) $______

- - - - - - - - - - - - - - -

7. [97] Cannot estimate

19. For 1983, estimate the number of additional hours, if any, management expended to comply with IRS' tip reporting regulations. Include time spent explaining regulations to employees and/or determining whether tip allocations were necessary. (CHECK ONE BOX.)

(48)

1. [2] 0 hours
2. [190] 1 - 50 hours
3. [126] 51 - 100 hours
4. [38] 101 - 150 hours
5. [51] 151 - 200 hours
6. [70] Over 200 hours (please specify) ______

- - - - - - - - - - - - - - - -

7. [72] Cannot estimate

20. Estimate the number of hours, if any, your establishment currently spends on a weekly basis to comply with IRS' tip reporting regulations. (CHECK ONE BOX.) (49)

1. [10] 0
2. [47] Less than 30 minutes
3. [123] 30 minutes to 1 hour
4. [149] More than 1 hour but less than 3 hours
5. [81] 3 hours to 5 hours
6. [53] More than 5 hours but less than 10 hours
7. [44] 10 hours or more (please specify) ______________

- - - - - - - - - - - - - - -

8. [40] Cannot estimate

D. TIP ALLOCATION PROCESS

If employees do not report to their employer tips which equal at least 8 percent of an establishment's gross sales, the employer must "allocate" tips to directly tipped employees.

21. Did this establishment allocate tips to employees during either 1983 or 1984? (CHECK ONE BOX.) (50)

1. [493] Yes
2. [164] No } (SKIP TO Q. 24)
3. [13] Don't know } (SKIP TO Q. 24)

22. Which of the following methods, if any, does your establishment use to allocate tips to your employees? (CHECK ALL THAT APPLY.)

1. [328] Employee hours worked (51)
2. [171] Employee gross sales (52)
3. [19] An agreement arranged between management and employees (53)
4. [6] Other, please specify (54)
____
____

23. How easy or difficult is the allocation method to apply? (CHECK ONE BOX.) (55)

1. [10] Very easy
2. [63] Easy
3. [162] Neither easy nor difficult
4. [190] Difficult
5. [67] Very difficult

E. RATE REDUCTION PROCESS

A rate reduction is an option employers can request.

24. Has this establishment submitted a request to IRS for an allocation rate lower than 8 percent? (CHECK ONE BOX.) (56)

1. [97] Yes (SKIP TO Q. 26)
2. [560] No } (CONTINUE TO Q. 25)
3. [15] Don't know } (CONTINUE TO Q. 25)

57

25. If this establishment <u>has not</u> submitted a request, which of the following was the primary reason for your decision <u>not</u> to apply for a lower allocation rate? (CHECK ONE BOX, THEN SKIP TO Q. 29.)
(57)

1. [322] Tipping rate in my establishment is 8 percent or greater
2. [61] Not aware of process for requesting a lower allocation rate
3. [102] The complexity of the process
4. [7] The difficulty of the instructions
5. [13] The length of time required
6. [46] Other, please specify ______________

(SKIP TO QUESTION 29)

26. If you have submitted a request, how satisfied or dissatisfied were you with each of the following aspects of the process? (CHECK ONE BOX IN <u>EACH</u> ROW.)

ASPECTS OF THE PROCESS	Very satisfied (1)	Satisfied (2)	Neither satisfied nor dissatisfied (3)	Dissatisfied (4)	Very dissatisfied (5)	
1. The amount of work required to submit the request		6	28	38	19	(58)
2. The clarity of the instructions		8	25	26	33	(59)
3. The length of time required to obtain an IRS decision	1	15	31	21	21	(60)
4. Other, please specify ______________				1	10	(61)

27. Which of the following represents the action IRS took on your request for a lower allocation rate? (CHECK ONE BOX.)
(62)

1. [43] IRS approved request
2. [38] IRS denied request
3. [12] IRS decision is pending

28. How long did the process take (or has the process taken, so far)? (ENTER MONTHS.)

4.0 (mean) (63-64)
(Months)

F. IMPACT OF REGULATIONS

29. Approximately what was the total amount of tips reported to you in 1982, 1983, and 1984? (ENTER AMOUNTS)

1. 1982 $62,743 (mean) (65-71)
2. 1983 $75,457 (mean) (72-78)
3. 1984 $90,899 (mean) (79-84)

30. If there was a change in the amount of tips employees reported after TEFRA (April 1983), to what extent, if any, did the IRS tip reporting requirements contribute to the change? (CHECK ONE BOX. IF THERE WAS NO CHANGE, PLEASE CHECK "NOT APPLICABLE.")
(85)

1. [84] Very great extent
2. [84] Great extent
3. [124] Moderate extent
4. [98] Some extent
5. [92] Litte or no extent

- - - - - - - - - - - - - - -

6. [105] Not applicable

31. Do any of your employees share tips, that is, do they split or pool tips? (CHECK ONE BOX.)
(86)

1. [194] Yes
2. [453] No (SKIP TO Q. 36)

32. Which of the following represents your employees' tip sharing method? (CHECK ALL THAT APPLY.)

1. [144] Tip splitting with indirectly tipped and nontipped employees (87)
2. [59] Tip pooling with other directly tipped employees (88)
3. [13] Other tip sharing arrangements, please specify (89)

____

____

33. How much of a problem, if at all, does this tip sharing arrangement create for you when determining whether tip allocation is necessary? (CHECK ONE BOX.)
(90)

1. [31] Very great problem
2. [14] Great problem
3. [44] Moderate problem
4. [36] Some problem
5. [62] Little or no problem

- - - - - - - - - - - - - - -

6. [23] No basis to judge

34. How much of a problem, if at all, does this tip sharing arrangement create for you when determining the amount of tips to allocate to each employee? (CHECK ONE BOX.) (91)

1. [26] Establishment has not allocated tips to employees
2. [21] Very great problem
3. [16] Great problem
4. [33] Moderate problem
5. [10] Some problem
6. [61] Little or no problem } (SKIP TO Q. 36
7. [26] No basis to judge }

35. Is the problem that tips per employee are underestimated or overestimated or is there another problem? (CHECK ONE BOX.) (92)

1. [29] Underestimated amount of tips per employee
2. [21] Overestimated amount of tips per employee
3. [24] Other, please specify

____

____

36. If you have additional comments regarding any previous question or general comments concerning IRS' new tip reporting requirements, please use the space below, and, if necessary, you may attach additional pages. (93)

GHQ/MMS-GGD/6/85

(TEAR LINE)

- -

(THE FOLLOWING SECTION WILL ULTIMATELY BE SEPARATED FROM THE QUESTIONNAIRE.)

****

Please enter below the name, title, and telephone number of the individual who should be contacted if clarification or any additional information is needed.

NAME: ______________________________________

TITLE: ______________________________________

TELEPHONE: __________ ______________
(Area code) (Number)

****

Thank you for your help!

Sampling and Data Analysis Methodology

This appendix describes how we selected the establishments in our sample and how we projected the sample data. Included in this appendix are tables showing the statistical sampling errors for the major figures in the report.

Sampling Methodology

Statistical sampling enables us to draw conclusions about the universe of interest on the basis of information in a sample of that universe. The results from a statistical sample are always subject to some uncertainty or sampling error because only a portion of the universe has been selected for analysis.

Our particular sample of establishments is only one of a large number of samples of equal size and design which could have been selected. Each of these samples would produce a different value for most characteristics being estimated. An estimate's sampling error measures the variability among the estimates obtained for all the possible samples. Sampling error thus is a measure of the precision or reliability with which an estimate from a particular sample approximates the results of a complete census. From the sample estimate, together with an estimate of its sampling error, interval estimates can be constructed with prescribed confidence that the interval includes the average result of all possible samples.

For example, from our sample survey we project that about 302 establishments with gross income between $1 and $49,999 had not experienced an increase in reporting of tips after the implementation of TEFRA. Using a sampling error formula, we had a 95-percent chance of producing a set of limits that encloses the true number of establishments. For this sample estimate of 302 establishments, our lower and upper limits were 192 and 463, respectively.

Sample Selection and Scope

Our universe of establishments included only those restaurants that complied with TEFRA's reporting requirements in 1983. We excluded from this universe any establishments that had been either closed or sold from the time they reported this information to IRS and the time of our survey. The nationwide sample was then selected by stratifying on the basis of gross receipts. Table IV.1 shows the number of cases in our sample and the universe from which these cases were selected.

Table IV.1: GAO's Sample of Restaurants That Complied With TEFRA's Reporting Requirements in 1983 (By Gross Receipts)

Strata	Sample	Universe
Receipts unknown (zero)	42	228
$1-$49,999	154	2,447
$50,000-$99,999	109	2,870
$100,000-$249,999	178	9,254
$250,000-$499,999	243	12,378
$500,000-$999,999	187	11,031
$1,000,000-$9,999,999	166	5,648
$10,000,000 and over	23	25
Total	**1,102**	**43,881**

Projection of Sample Results

Although our sample consisted of 1,102 establishments, each establishment represented a member of a larger universe and, therefore, their responses could be "weighted" to project to the total universe.

The following example illustrates our weighted methodology. In the strata of establishments with gross receipts between $50,000 and $99,999, there were 2,870 establishments of which we took a sample of 109. We calculated the weighted factor by dividing the stratum universe size by the sample size (2870/109=26.33). Therefore, any condition observed in one establishment with gross receipts between $50,000 and $99,999 could be projected to 26.33 establishments in the universe. Table IV.2 lists the strata and the weights associated with each.

Table IV.2: Weights Assigned to GAO's Sample of Restaurants That Complied With TEFRA in 1983 (By Gross Receipts)

Strata	Sample	Weight	Universe
Receipts unknown (zero)	42	5.43	228
$1-$49,999	154	15.89	2,447
$50,000-$99,999	109	26.33	2,870
$100,000-$249,999	178	51.99	9,254
$250,000-$499,999	243	50.99	12,378
$500,000-$999,999	187	58.99	11,031
$1,000,000-$9,999,999	166	34.02	5,648
$10,000,000 and over	23	1.09	25
Total	**1,102**		**43,881**

Sampling Errors on Tip Income Reporting Data

Our sampling plan was designed to provide a sample size that would yield an expected sampling error of not greater than 10 percent on a response upheld by 50 percent of the universe (at the 95 percent confidence level). However, the actual sampling error on any particular response estimate depends on the percentage of establishments upholding that response, the percentage of establishments in which data was not available for a particular response and the distribution of the responses for each characteristic or variable.

To show the reader the size of the sampling errors, some individual sampling errors were calculated. We calculated the sampling errors for estimates that were subject to large sampling errors relative to the size of the estimate and to those estimates that were crucial to our report findings. The upper and lower limits of these estimates were then calculated. These limits are shown in the following tables.

Table IV.3: Confidence Limits for Selected Universe Estimates

	Confidence interval (95 percent)		
Description of establishment	Universe estimate	Lower limit	Upper limit
Percent of those with initial cost of $2,000 or less to comply with TEFRA	68	64	71
Percent of those with recurring cost of $2,000 or less to comply with TEFRA	70	67	74
With initial cost of $2,000 or less to comply with TEFRA	14,664	14,224	15,104
With recurring cost of $2,000 or less to comply with TEFRA	15,065	14,613	15,517
With initial cost to comply with TEFRA	21,604	21,213	22,228
With recurring cost to comply with TEFRA	21,483	20,866	22,100

Table IV.4: Confidence Limits for Food and Beverage Establishments' Initial Cost to Comply With TEFRA's Reporting Requirements

	Start-up cost							
Establishment size by gross receipts	**No cost**	**$1 to $500**	**$501 to $1,000**	**$1,001 to $1,500**	**$1,501 to $2,000**	**Over $2,000**	**Cannot estimate**	**Total establishments**
$1 to $49,999								
Number	32	493	79	64	95	127	222	1,112
limits	31 to 33	443 to 543	75 to 83	61 to 67	90 to 100	119 to 135	204 to 240	1,032 to 1,192
$50,000 to $99,999								
Number	26	421	211	79	184	105	237	1,263
limits	25 to 27	378 to 464	195 to 227	75 to 83	171 to 197	99 to 111	218 to 256	1,130 to 1,396
$100,000 to $249,999								
Number	0	1,820	832	468	364	728	676	4,888
limits	0 to 190	1,669 to 1,971	780 to 884	446 to 490	348 to 380	685 to 771	638 to 714	4,541 to 5,235
$250,000 to $499,999								
Number	0	2,649	866	408	255	815	917	5,910
limits	0 to 187	2,450 to 2,848	823 to 909	394 to 422	248 to 262	776 to 854	870 to 964	5,514 to 6,306
$500,000 to $999,999								
Number	177	1,593	1,003	472	531	826	885	5,487
limits	172 to 182	1,470 to 1,716	938 to 1,068	450 to 494	505 to 557	776 to 876	830 to 940	5,097 to 5,877
$1,000,000 to $9,999,999								
Number	0	680	204	510	374	1,021	374	3,163
limits	0 to 123	632 to 728	196 to 212	478 to 542	354 to 394	938 to 1,104	354 to 394	2,948 to 3,378
$10,000,000 and Over								
Number	0	1	1	4	3	4	3	16
limits	0 to .25	0 to 1	0 to 1	3 to 5	2 to 4	3 to 5	2 to 4	16 to 17
Total establishments								
Number	235	7,657	3,196	2,005	1,806	3,626	3,314	21,839
limits	233 to 237	7,381 to 7,933	3,110 to 3,282	1,963 to 2,047	1,770 to 1,842	3,528 to 3,724	3,228 to 3,400	21,140 to 22,538

Table IV.5: Confidence Limits for Type of Cost Incurred by Food and Beverage Establishments to Comply With TEFRA's Reporting Requirements

	Type of cost					
Establishment size by gross receipts	**Overtime**	**Use of consultants**	**Hired additional employees**	**Purchased computer software**	**Purchased computer**	**Other**
$1 to $49,999						
Number	620	461	127	667	32	143
limits	555 to 685	415 to 507	119 to 135	597 to 734	31 to 33	134 to 152
$50,000 to $99,999						
Number	474	579	342	579	53	132
limits	424 to 524	514 to 644	310 to 374	514 to 644	51 to 55	124 to 140
$100,000 to $249,999						
Number	2,184	2,496	572	2,755	416	520
limits	1,994 to 2,374	2,274 to 2,718	542 to 602	2,507 to 3,003	397 to 435	493 to 547
$250,000 to $499,999						
Number	2,700	3,668	1,477	2,343	917	1,172
limits	2,499 to 2,903	3,378 to 3,958	1,385 to 1,569	2,174 to 2,512	870 to 964	1,106 to 1,238
$500,000 to $999,999						
Number	2,773	2,360	1,416	2,006	531	944
limits	2,523 to 3,023	2,155 to 2,565	1,311 to 1,521	1,840 to 2,172	505 to 557	885 to 1,003
$1,000,000 to $9,999,999						
Number	1,667	1,463	884	1,871	306	204
limits	1,515 to 1,819	1,333 to 1,593	815 to 953	1,699 to 2,043	291 to 321	196 to 212
$10,000,000 and Over						
Number	11	4	3	11	0	0
limits	10 to 12	3 to 5	2 to 4	10 to 12	0 to .25	0 to .25
Total establishments						
Number	10,429	11,031	4,821	10,232	2,255	3,115
limits	10,022 to 10,836	10,590 to 11,472	4,672 to 4,970	9,843 to 10,621	2,203 to 2,307	3,034 to 3,196

Table IV.6: Confidence Limits for Recurring Cost Encountered by Food and Beverage Establishments to Comply With TEFRA's Reporting Requirements

	Recurring cost							
Establishment size by gross receipts	No cost	$1 to $500	$501 to $1,000	$1,001 to $1,500	$1,501 to $2,000	Over $2,000	Cannot estimate	Total establish-ments
$1 to $49,999								
Number	32	302	318	48	64	95	254	1,113
limits	31 to 33	275 to 329	289 to 347	46 to 50	61 to 67	90 to 100	233 to 275	1,033 to 1,193
$50,000 to $99,999								
Number	53	606	237	53	105	105	105	1,264
limits	51 to 55	538 to 674	218 to 256	51 to 55	99 to 111	99 to 111	99 to 111	1,131 to 1,397
$100,000 to $249,999								
Number	104	2,184	936	260	312	468	676	4,940
limits	102 to 106	1,994 to 2,374	875 to 997	250 to 270	300 to 324	446 to 490	637 to 715	4,599 to 5,281
$250,000 to $499,999								
Number	204	2,445	611	560	306	408	1,375	5,909
limits	199 to 209	2,267 to 2,623	585 to 637	537 to 583	297 to 315	394 to 422	1,292 to 1,458	5,513 to 6,305
$500,000 to $999,999								
Number	118	1,652	944	590	649	531	1,003	5,487
limits	115 to 121	1,523 to 1,781	885 to 1,003	560 to 620	614 to 684	505 to 557	938 to 1,068	5,097 to 5,877
$1,000,000 to $9,999,999								
Number	34	646	578	306	340	918	476	3,298
limits	33 to 35	601 to 691	540 to 616	291 to 321	322 to 358	845 to 991	447 to 505	3,097 to 3,499
$10,000,000 and Over								
Number	0	1	9	2	1	2	2	17
limits	0 to .25	0 to 1	8 to 10	1 to 3	0 to 1	1 to 3	1 to 3	16 to 17
Total establishments								
Number	545	7,836	3,633	1,819	1,777	2,527	3,891	22,028
limits	539 to 551	7,554 to 8,118	3,535 to 3,731	1,783 to 1,855	1,741 to 1,813	2,471 to 2,583	3,782 to 4,000	21,323 to 22,733

Comments From the Internal Revenue Service

COMMISSIONER OF INTERNAL REVENUE
Washington, DC 20224

JUL 28 1986

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Thank you for the opportunity to review your draft report entitled "Tax Administration: Tip Income Reporting Can Be Increased".

We agree with the general thrust of your report. Detailed responses to the report recommendations are enclosed.

Sincerely,

Acting Commissioner

Enclosure

Department of the Treasury Internal Revenue Service

IRS COMMENTS ON GAO DRAFT REPORT
"TAX ADMINISTRATION: TIP INCOME REPORTING
CAN BE INCREASED"

Now on p. 21.

Recommendation (Page 20)

To improve the Service's efforts to improve compliance with the requirements for reporting tip income, we recommend that the Commissioner of Internal Revenue formulate and implement an overall strategy for identifying and reducing tip income nonreporting. In formulating this strategy, the Commissioner should, in conjunction with providing TEFRA tip income information to the regional and district offices,

--identify and evaluate for Service-wide applicability, those detection techniques and tools which have proved effective in conducting tip income reporting projects and communicate this information to all IRS regions and districts.

--design and implement an overview and evaluation process to monitor the progress of tip enforcement activities, identify potential problem areas, and devise the action(s) needed to deal with them.

Response

The Service is currently conducting the congressionally mandated TEFRA Tip Income Study which is to be completed by January 1, 1988. This study will provide information on compliance levels and the nature of noncompliance and identify the types of establishments and geographical areas that are most noncompliant. District offices may conduct local tip projects when they determine that these will be effective in collecting revenue and enhancing voluntary compliance. Ultimately, districts will be able to evaluate their own experiences with the study and determine the nature of local noncompliance and the yield to cost effectiveness of implementing additional tip projects. In addition, the study will provide a nationwide core group of trained examiners and establish procedures for conducting future tip projects to supplement those activities which are currently on-going in the field.

Detection techniques and tools which have proved effective in conducting tip income reporting projects have been communicated and made available to all regions and districts. For example:

a. The Western Region computer system for tip projects is available to all regions and is being used in four of the seven regions. Those regions not using the system decided to use other alternatives, such as microcomputers. In addition, all of the available computerized systems are being evaluated for inclusion in the Automated Examination System which should be available in 1989.

-2-

b. Annually, districts are provided listings of establishments with potentially noncompliant employees. These lists are developed through a computerized selection system using criteria which identify those establishments with high tipping rates and low reported tips. Each region is also provided with a magnetic tape copy of Forms 8027 so they can use their own computerized selection criteria to identify establishments with the most significant noncompliance.

Districts and regions are responsible for the initiation and monitoring of local tip income projects. We have designated a separate code (132) in our Examination Management Information System for tip income projects, which are compared on a U.S., regional and district basis. As of April 30, 1986, every region and 42 district offices reported accomplishments under the Tip Income Project Code (132).

Now on p. 31.

Recommendation (Pages 35 and 36)

To reduce the inconsistencies in the rate reduction process, we recommend that the Commissioner of Internal Revenue (1) establish uniform criteria and standard procedures for reviewing employers' requests for a reduction from the reporting of 8 percent of gross receipts as tip income, and (2) monitor the implementation of the review process to assure a reasonably consistent Service-wide approach.

Response

Revenue Procedure 85-4 is very specific on the types of information that establishments or employees are to provide in their rate reduction requests. Districts may require additional evidence, if deemed necessary. Each district evaluates the evidence based on its assessment of local conditions to determine the merits of the rate reduction request. While instructions will be issued on how the information is to be evaluated, this is a subjective area that does not lend itself to uniform criteria. Consequently, IRS personnel will still consider local conditions and rely heavily on their own judgments in analyzing the facts and circumstances.

There is no monitoring of the determination process itself. However, there is an appeals process for applicants who are unsatisfied with a district's determination. There have been very few appeals filed. We will require the regions to more closely monitor the process to ensure consistent treatment of applicants.

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