
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



*Billions in Tip-Related Tax Noncompliance
Are Not Fully Addressed and Tip Agreements
Are Generally Not Enforced*

September 28, 2018

Reference Number: 2018-30-081

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Redaction Legend:

1 = Tax Return/Return Information

2 = Law Enforcement Techniques/Procedures and Guidelines for Law Enforcement Investigations or Prosecutions

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HIGHLIGHTS

BILLIONS IN TIP-RELATED TAX NONCOMPLIANCE ARE NOT FULLY ADDRESSED AND TIP AGREEMENTS ARE GENERALLY NOT ENFORCED

Highlights

**Final Report issued on
September 28, 2018**

Highlights of Reference Number: 2018-30-081
to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

Tips are considered wages and are subject to employment taxes including Federal Insurance Contributions Act, Federal Unemployment Tax Act, and Federal income tax withholding. If the IRS does not enforce underreported tip income by employees and employers, it is unfair to those taxpayers who do report and pay tax on tip income accurately.

WHY TIGTA DID THE AUDIT

The IRS estimates that 10 percent (\$23 billion) of the estimated 2006 individual income tax underreporting Tax Gap (\$235 billion) is due to unreported tip income by employees. The overall objective of this audit was to determine whether the IRS is using the National Tip Reporting Compliance Program (NTRCP) to provide balanced and adequate reporting compliance oversight of taxpayers in industries in which tipping is customary.

WHAT TIGTA FOUND

The NTRCP prioritized the renewal of lower risk Gaming Industry Tip Compliance Agreements (GITCA) and Tip Rate Determination Agreements (TRDA) over higher risk compliance reviews of Tip Reporting Alternative Commitment (TRAC) agreements and tip examinations. Since Fiscal Year (FY) 2013, the NTRCP completed 875 GITCA and TRDA renewals compared with 262 tip examinations and 53 TRAC reviews.

TIGTA determined that 1,971 (30 percent) of the 6,513 businesses with tip agreements that also filed taxes during Tax Year 2016 had projected

unreported tips of nearly \$1.66 billion. Employers with TRAC agreements accounted for 815 (41 percent) of this noncompliance, involving almost \$1.2 billion (72 percent), including 47 full-service restaurants that potentially underreported by over \$1 million each. The IRS provided tip income audit protection to these potentially noncompliant businesses and employees.

There is an even higher risk of tax noncompliance for employers in tipping industries that do not have a tip agreement. TIGTA identified 15,771 employers with \$6.3 billion in projected unreported tip income for Tax Year 2016, including 676 employers who underreported by over \$1 million. Meanwhile, the NTRCP completed only 34 tip examinations of employers in FY 2016.

IRS management believes that focusing on the renewal of GITCAs allows them to reach and maintain compliance for a large number of employers and their employees all at once. However, TIGTA determined that **1** of 10 randomly sampled FY 2017 GITCA and TRDA renewal reviews resulted in either no change to the tip rates or a reduction by an average of 17 percent. In addition, unlike TRACs, GITCA and TRDA employers must submit annual reports that the NTRCP can use to assess the risk of noncompliance.

TIGTA's review of the 10 most recently completed tip agreement compliance reviews showed that the NTRCP examiners had documented at least one reason to revoke the tip agreements in **1** cases, but the agreements were not revoked. The NTRCP has revoked only 13 tip agreements since FY 2013.

WHAT TIGTA RECOMMENDED

TIGTA made nine recommendations to improve the NTRCP's administration of tip agreements and examinations.

In response to the report, IRS management agreed with the recommendations and plans to take corrective actions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 28, 2018

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced (Audit # 201730036)

This report presents the results of our review to determine whether the Internal Revenue Service is using the National Tip Reporting Compliance Program to provide balanced and adequate reporting compliance oversight of taxpayers in industries in which tipping is customary. This review is included in our Fiscal Year 2018 Annual Audit Plan and addresses the major management challenge of Improving Tax Compliance.

Management's complete response to the draft report is included as Appendix VIII.

If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).



*Billions in Tip-Related Tax Noncompliance Are Not Fully
Addressed and Tip Agreements Are Generally Not Enforced*

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Abbreviations

CETO	Centralized Employment Tax Operations
ECS	Exam Case Selection
emTRAC	Employer-Designed Tip Reporting Alternative Commitment
FICA	Federal Insurance Contributions Act
FY	Fiscal Year
GITCA	Gaming Industry Tip Compliance Agreement
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LB&I	Large Business and International
2	*****2*****
NTRCP	National Tip Reporting Compliance Program
SB/SE	Small Business/Self-Employed
TE/GE	Tax Exempt and Government Entities
TIGTA	Treasury Inspector General for Tax Administration
TRAC	Tip Reporting Alternative Commitment
TRDA	Tip Rate Determination Agreement
TY	Tax Year



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

Background

Tips are considered wages and are subject to employment taxes including Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act, and Federal income tax withholding.¹ Tips have various reporting requirements for the employee and the employer. To help employees accurately report their tip income and employers to meet their filing and reporting obligations, the Internal Revenue Service (IRS) created the National Tip Reporting Compliance Program (NTRCP). The mission of the NTRCP is to implement policies and strategies for tip filing, reporting, and payment. To accomplish this goal in part, the NTRCP has developed tip agreements to encourage current and ongoing voluntary compliance with the tipping taxpayer community. The NTRCP allows participating employers to enter voluntarily into a tip compliance agreement with the IRS in which both sides agree to satisfy certain obligations under the particular agreement.² For example, tip agreements may require minimum tip reporting rates for specific occupations in the business, and may require certain thresholds of employee participation. In addition, tip agreements require employers to establish procedures and reporting systems to ensure accurate tip reporting and to institute and maintain regular tip reporting educational programs for employees. As long as both the employees and employer are complying with the requirements under the agreement, no tip audits will be initiated on either the employer or the employees.

The Internal Revenue Service created the National Tip Reporting Compliance Program to help employees accurately report their tip income and employers to meet their filing and reporting obligations.

The NTRCP identifies tipping businesses as either gaming or non-gaming. Gaming includes such businesses as casinos, racinos,³ card rooms, and slot parlors and generally include many different occupations that receive tips. Non-gaming includes food and beverage (e.g., restaurants, bars, nightclubs), personal services (e.g., salons, manicurists, estheticians, barbers, spas), hospitality (e.g., hotels, resorts), and transportation (e.g., taxis, limousines, airport skycap, carwash operations) as well as sports and recreation (e.g., golf clubs, cruise ships, tour guide establishments).

Currently, there are four different voluntary tip compliance agreements available for use by employers in the tipping industry. Specifically, the:

- ***Gaming Industry Tip Compliance Agreement (GITCA)*** is used for gaming establishments in which the IRS works with the employer to arrive at minimum tip

¹ Internal Revenue Manual (IRM) 4.23.7.1(3) (Jan. 13, 2014). See Appendix VII for a glossary of terms.

² The IRS reviews participating employer's financial information to determine if they are currently in compliance before they can enter into a tip agreement.

³ Combined racetrack and casino.



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reporting rates for various occupations in the establishment by using the company's historical tip data.⁴ These rates are subject to review and validation by the IRS every three years when the agreements expire. At least 75 percent of the tipped employees in the establishment must also participate by signing a Model Gaming Employee Tip Reporting Agreement and they must report tips at or above the rate determined in the agreement. In addition, employers are required to provide the IRS with an annual report showing each nonparticipant employee. In Fiscal Year (FY) 2017, there were 439 GITCAs in place.

- ***Tip Rate Determination Agreement (TRDA)*** is used for non-gaming establishments in which the IRS will work with the employer to arrive at minimum tip reporting rates for various occupations in the establishment by using the company's historical tip data.⁵ TRDAs do not have an expiration date, but the IRS monitors the participating employer and employees for compliance on an annual basis. At least 75 percent of tipped employees must sign a participation agreement consenting to participate. Participating employees must report tips at or above the rate determined in the agreement. In addition, employers are required to provide the IRS with an annual report showing each nonparticipant employee. In FY 2017, there were 3,039 TRDAs in place.
- ***Tip Reporting Alternative Commitment (TRAC)*** is used for non-gaming establishments in which the employer agrees to establish a reasonable procedure for accurate tip reporting by all tipped employees, institute and maintain a quarterly educational training program that trains newly hired employees on their tip reporting obligations, and periodically update existing employees on their obligations.⁶ These agreements have no expiration, but participating employers and employees are subject to compliance reviews by the IRS. In FY 2017, there were approximately 65,000 TRACs in place.
- ***Employer-Designed Tip Reporting Alternative Commitment (emTRAC)*** is used for non-gaming establishments in which any food or beverage establishment can develop its own tip compliance program.⁷ This agreement maintains the same filing, reporting, and educational requirements as an IRS-administered TRAC. Employers must apply in writing to obtain IRS approval of their programs and receive the same benefits and protections afforded under a TRAC. In FY 2017, there were 10 emTRACs in place.

Tip agreements for tip establishments (GITCA/TRDA) are usually initiated by the IRS. However, tip establishments are able to request an agreement without the IRS initiating it. The IRS relies upon non-gaming establishments to initiate a request for a TRAC/emTRAC tip agreement.

⁴ IRM 4.23.7.10.6.1(2) (Dec. 18, 2012).

⁵ IRM 4.23.7.10.3 (Jan. 22, 2010).

⁶ IRM 4.23.7.10.4 (Jan. 22, 2010).

⁷ IRM 4.23.7.10.5 (Jan. 22, 2010).



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Employment tax tip examinations are initiated when it is determined that an employer without a tip agreement is reporting low or zero tips on its Form 941, *Employer's Quarterly Federal Tax Return*, and tipping is customary in the employer's industry. On June 17, 2002, the Supreme Court rendered a decision in favor of the IRS in *Fior D'Italia, Inc v. U.S.*⁸ The Court held that the IRS has the authority to decide how to calculate and make an assessment of the taxpayer's FICA tax liability on tips received by its employees as long as the method used to make the estimate is not unreasonable.

In light of this case, the IRS may generally conduct tip examinations and make assessments for Social Security and Medicare taxes on employers only, using a reasonable methodology, without first examining the tip records of the individual employees. When an employee fails to report tips to his or her employer, the employer is not liable for its share of the Social Security and Medicare taxes on the unreported tips until the IRS makes Notice and Demand to the employer.⁹ The employer is liable for the employer's share of Social Security and Medicare taxes for tips even though the employees failed to provide the employer with written statements. The additional tax liability may be based upon the employer's records for the tax year and/or on Forms 4137, *Social Security and Medicare Tax on Unreported Tip Income*, filed by employees.¹⁰ The additional tax liability is not due until the IRS issues a Letter 3263-E, *Notice and Demand under Section 3121(q)*, (hereafter referred to as the Notice and Demand letter).¹¹ The Internal Revenue Code (I.R.C.) Section (§) 3121(q) FICA tax liability is treated as a current tax liability and the employer is to report it on a current period Form 941 as instructed in the letter.

High growth in the food and beverage and gaming industries in recent years presents a challenge for the already resource-constrained IRS to improve employer and employee compliance in the tipping industries. For example, the National Restaurant Association's 2017 Restaurant Industry Outlook stated that total sales from all food and beverage sales across the United States was expected to reach \$799 billion and that these businesses were expected to employ 14.7 million workers, making the food and beverage industry the second largest private employer in the United States.¹² In 2017, the American Gaming Association reported that 17 of the 24 States with commercial casinos had growth in gross gaming revenues from 2015 to 2016, with record revenues recorded in Florida, Maine, Maryland, Massachusetts, New York, Ohio, Pennsylvania and Rhode Island.¹³

The IRS stated one of its goals in administering the NTRCP is to reduce the tip reporting portion of the Tax Gap.¹⁴ From the estimated individual income tax underreporting Tax Gap estimate of

⁸ *Fior D'Italia, Inc. v. U.S.*, 536 U.S. 238 (2002).

⁹ I.R.C. § 3121(q).

¹⁰ Form 4137 is filed by individual taxpayers with Form 1040, *Individual Income Tax Return*, when reporting tip income not originally reported to the employer.

¹¹ See Appendix V for a copy of the Letter 3263-E used for tip examinations.

¹² National Restaurant Association, *2017 National Restaurant Association Restaurant Industry Outlook* (2017).

¹³ American Gaming Association, *State of the States: The AGA Survey of the Casino Industry* (2017).

¹⁴ IRM 4.23.7.10.6.4 (Dec. 18, 2012).



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\$235 billion for Tax Year (TY) 2006, the IRS estimates there were unreported tips by employees of \$23 billion (10 percent).¹⁵ The \$23 billion in unreported tips accounts for 52 percent of the estimated individual tip income in TY 2006 of \$44 billion.

The NTRCP has two groups of revenue agents who perform the work needed to approve new tip applications, renew expiring tip agreements, add locations to tip agreements, and audit employers with tip income that do not have tip agreements. Revenue agents are also involved in education outreach for the NTRCP. One examination group comprised of 10 revenue agents is based in Las Vegas and Reno, Nevada, and the other group has six agents and three examiners scattered around the country. In addition, a group of 24 tax examiners in the Centralized Employment Tax Operations (CETO) function located in Detroit, Michigan, work mainly notice and compliance workstreams for the NTRCP.¹⁶ All of the IRS tip compliance policy, regardless of operating division, is coordinated through the NTRCP, which is positioned under the Small Business/Self-Employed (SB/SE) Division Specialty Examination function's Employment Tax program.

This review was performed at the Detroit, Michigan, and Las Vegas, Nevada, offices of the SB/SE Division Specialty Examination function's Employment Tax program during the period August 2017 through June 2018. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

¹⁵ The IRS informed us that it does not have an individual unreported tip estimate for the reported TY 2008–2010 Tax Gap.

¹⁶ Examples of work performed by the CETO function are Form 4137 Compliance; Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips*, Nonfiler Soft Notices; Unreported Tip Income Soft Notices; and Form 941/944 Mismatch. Note: Form 944, *Employer's Annual Federal Tax Return*.



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Results of Review

Lower Risk Rate Reviews Are Prioritized Over Higher Risk Compliance Reviews and Tip Examinations

Revenue agents in the NTRCP perform the work needed to approve new tip agreements, renew expiring tip agreements, add locations to existing tip agreements, and monitor tip agreements for compliance. More specifically,

- Rate reviews are performed by revenue agents using historical tip receipt records to calculate an agreed-upon tip rate for the different job categories in an establishment (such as a casino) applying for a new GITCA or TRDA agreement or requesting renewal of an expiring GITCA agreement.¹⁷ GITCAs have a three-year term, which may be extended. However, GITCAs are generally not renewed unless a new rate review is performed. TRDAs do not have an expiration date.
- Compliance reviews are performed by revenue agents to monitor the employer's compliance with commitments made in the tip agreement, usually for TRACs.¹⁸ The employer's records are reviewed to determine if they are accurately filing and reporting tip income, educating employees on tip reporting requirements, and maintaining an employee tip reporting process, as per the terms of the agreement.
- Addendum rate reviews are performed by revenue agents for various reasons, such as when the business changes ownership or when the business adds new employee positions, venues, or shifts.
- Tip examinations are initiated by the IRS and are performed by NTRCP revenue agents when it is determined that an employer in a tipping industry establishment is reporting low or zero tips on its Form 941 or if analysis of an employer's tip reporting indicates a significant amount of unreported tips.¹⁹

Review of the NTRCP Field Examination workstream data for FYs 2013 through 2017 showed that only 53 compliance reviews were completed, and the majority (36) of them were completed in FY 2013. Since FY 2014, the NTRCP has conducted a total of 17 compliance reviews. During the same time, the NTRCP completed 875 rate reviews. Figure 1 shows how many of each type of review the NTRCP completed since FY 2013.

¹⁷ IRM 4.23.7.10.6.3 (Dec. 18, 2012).

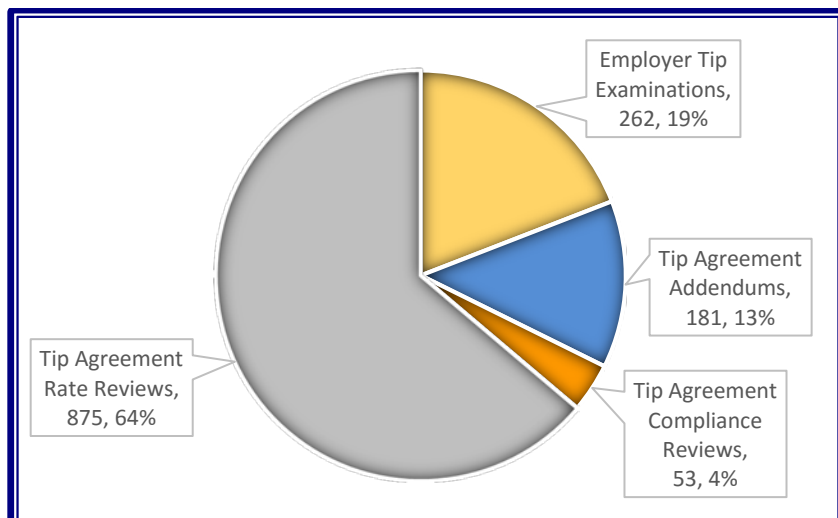
¹⁸ IRM 4.23.7.7(3) (Jan. 22, 2010).

¹⁹ IRM 4.23.7.7(1) (Jan. 22, 2010).



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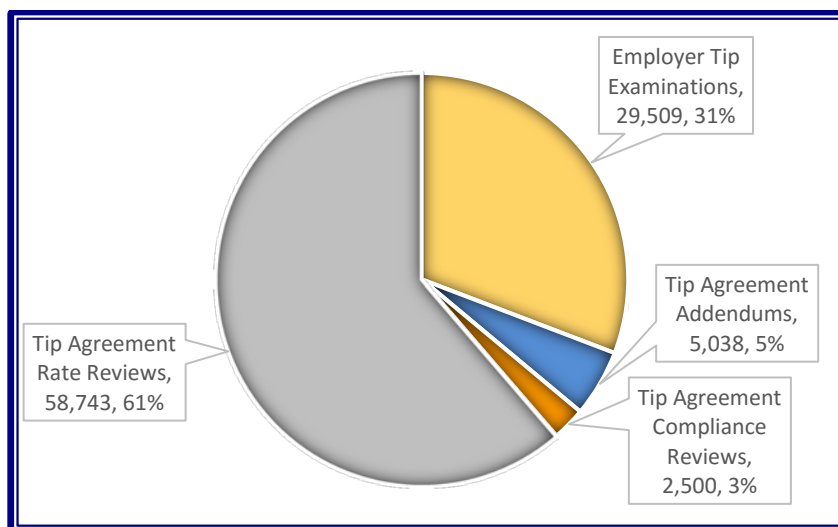
**Figure 1: NTRCP Field Examination
Total Workstream Closures for FYs 2013–2017**



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS NTRCP workstream closures.

Tip agreement rate reviews over the five fiscal years accounted for 64 percent (875 of 1,371) of total Field Examination case closures, while compliance reviews accounted for only 4 percent (53 of 1,371) and tip examinations accounted for 19 percent (262 of 1,371) of total Field Examination closures. The remaining 13 percent (181 of 1,371) of closures were tip agreement addendum cases. Figure 2 shows the number of NTRCP hours charged to each type of review.

**Figure 2: NTRCP Field Examination
Total Work Hours for FYs 2013–2017**



Source: TIGTA analysis of IRS NTRCP workstream closures.



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Similarly, tip agreement rate review work hours over the five years accounted for 61 percent (58,743 of 95,790) of the total Field Examination work hours, while compliance reviews accounted for only 3 percent (2,500 of 95,790) and tip examinations accounted for 31 percent (29,509 of 95,790) of total Field Examination work hours. The remaining 5 percent of Field Examination work hours were spent on tip addendum cases.

Although the IRS was unable to provide us with the exact numbers regarding how many of the 875 rate reviews were related to GITCA renewals, management told us the NTRCP has been focusing the majority of Field Examination resources on renewing expiring GITCA agreements. Revenue agents we interviewed in Las Vegas said the majority of their time was spent on these rate reviews in FY 2017.

The emphasis on GITCA renewals appears to be related to several factors. IRS management explained that the NTRCP focuses on GITCA renewals because they affect the largest number of employees in the tip taxpayer community with each rate review. GITCA employers are predominately large, complex business operations that are comprised of a large number of tipped employees in various types of venues. Each GITCA rate review renewal includes all the establishments within the “four walls” of the property such as restaurants, spas, and hair salons. IRS management also explained that GITCA rate reviews in Las Vegas are the major focus every three years because they all expire at the same time. In the past, gaming employers with tip agreements complained about agreements expiring at different times because they were losing employees to industry competitors that were not subject to the tip rate changes that are possible after a rate review. For example, employees could shop for a casino that had lower tip reporting requirements and a longer time before the possibility of a change. To address this concern, the IRS changed the GITCA expiration dates to come due all at once according to geographic location. This policy change makes it difficult for NTRCP revenue agents to perform other work when larger sets of GITCAs are due to expire, such as the numerous casino establishments in Las Vegas. As a result, monitoring the compliance of establishments with TRAC agreements is not a priority, even though many of these businesses are noncompliant with the terms of the TRAC.

Hundreds of employers with TRAC tip agreements are not in compliance but continue to receive audit protection

IRS procedures state that tip compliance agreements should be monitored at least annually, and that monitoring is imperative to ensure that employers and their employees continue to report their tip income accurately and are compliant with the terms of the agreement.²⁰ Follow-up procedures for employers participating in a TRAC, TRDA, GITCA, or emTRAC agreement include a review of the employer’s Forms 941.²¹ When employers enter into a TRAC agreement, the IRS informs the employer and employees that it will monitor tip reporting on Form 941 and

²⁰ IRM 4.23.7.12(1) and (6) (Dec. 18, 2012).

²¹ IRM 4.23.7.12(2) (Dec. 18, 2012).



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on Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips*, for a food or beverage business.²² When employees do not report all their tip income to the employer as required, reviews of the tip income reported by the employer on Forms 941 and 8027 can determine the potential for underreported tips in the food and beverage industry. For example, underreported tips may be present if the Form 8027 shows charged tips are greater than total tips reported on Forms 941 or if the Form 8027 indicates there is a significant disparity between the charge tip rate and the cash tip rate. In these instances, it is also likely the employees themselves will not report all the tip income they earned on their own tax returns (Form 1040, *U.S. Individual Income Tax Return*).

We analyzed 6,513 employer taxpayers with tip compliance agreements that filed a Form 1120, *U.S. Corporation Income Tax Return*; Form 1120S, *U.S. Income Tax Return for an S Corporation*; or Form 1065, *U.S. Return of Partnership Income*, and Form 941 for TY 2016. Our analysis identified 1,971 (30 percent) of 6,513 employers with projected unreported tips of nearly \$1.66 billion.²³ However, the IRS provided tip income audit protection to these potentially noncompliant businesses and employees. Figure 3 shows the type of tip agreements for the 1,971 employers with projected unreported tips.

**Figure 3: Projected Unreported Tips
by Employers by Tip Agreement Type**

Agreement Type	Count	Projected Unreported Tips	Percentage of Total Dollars
GITCA	90	\$182,541,506	11%
TRAC	815	\$1,199,585,389	72%
TRDA	1,066	\$273,909,638	17%
Total	1,971	\$1,656,036,534	100%

Source: TIGTA analysis of IRS tip compliance agreements.

²² Form 8027 is generally required to be filed by food and beverage establishments with more than 10 employees. IRM 4.23.7.10.4(1) (Jan. 22, 2010).

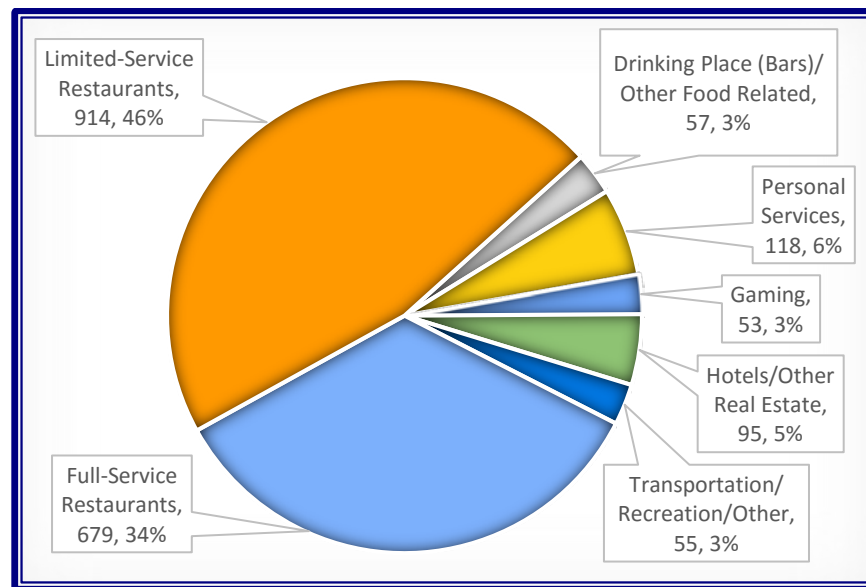
²³ We used the same criteria the IRS uses to identify tip industry taxpayers who are potentially underreporting their tip income: *****2*****
*****2*****
*****2***** The calculation is a reasonable estimate; however, actual results may vary depending on the possible inclusion of other income not associated with tipping, such as merchandise sales or rentals.



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

The data show that 815 (41 percent) of the 1,971 employers were under TRAC tip agreements that account for \$1.2 billion (72 percent) of the total \$1.66 billion in projected unreported tips, indicating significant risk of TRAC noncompliance. In comparison, TRDA and GITCA projected unreported dollars combined represents \$456 million (28 percent) of the \$1.66 billion. Figure 4 shows the 1,971 employers by industry type.

Figure 4: Tip Agreements With Projected Unreported Tips by Industry



Source: TIGTA analysis of IRS tip compliance agreements.

Our analysis identified that 1,711 (87 percent) of the 1,971 employers with projected unreported tips were from three main industries: limited-service restaurants (914), full-service restaurants (679), and personal services (118).²⁴ Employers in these three industries also accounted for \$703 million (42 percent) of the \$1.66 billion in projected unreported tips. Although there were 95 hotels/other real estate employers that accounted for more than \$400 million of projected unreported tips, we did not include these employers because much of their income may not be attributable to activities associated with tips. For example, hotel room rental income generally does not result in significant tip income.

Figure 5 shows that 647 (79 percent) of the 815 employers we identified with TRAC agreements came from the same three main industries.

²⁴ Personal Services include beauty salons; barber shops; cosmetics, beauty supply, and perfume stores; and all other personal services.



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Figure 5: TRAC Agreement Employers by Industry

Industry	Count	Projected Unreported Tips
Full-Service Restaurants	509	\$369,816,243
Limited-Service Restaurants	20	\$24,936,611
Personal Services	118	\$48,906,981

Source: TIGTA analysis of IRS tip compliance agreements.

Our analysis shows that 509 (62 percent) of the 815 employers with TRACs are full-service restaurants, and they represent almost \$370 million (31 percent) of the nearly \$1.2 billion of the projected unreported TRAC tip income. These numbers indicate significant noncompliance with TRACs in the full-service restaurant industry. We also determined that 47 of the 509 full-service restaurant TRACs had projected unreported tips over \$1 million, for a total of \$231 million.

Due to limited revenue agent resources in the NTRCP, IRS management has prioritized GITCA and TRDA monitoring over TRAC monitoring. IRS management stated they monitor TRDA and GITCA agreements on an annual basis during the end of the year reporting process. TRDA and GITCA agreements require employers to provide the IRS with an annual report showing each employee who is not participating in the tip agreement. The IRS can use those reports to identify employees who may be underreporting their tip earnings and refer the employees to be audited through correspondence examinations or mail soft notices to the employees to encourage them to report the unreported tips on an amended tax return. In addition, if TRDA or GITCA employers do not provide the annual report to the IRS, it signals that a review of the employer's Form 941 or Form 8027 may be needed. However, unlike TRDA and GITCA agreements, TRAC agreements do not have an annual reporting requirement. Therefore, monitoring of TRAC agreement employers and employees is more time-consuming and is not prioritized in the NTRCP.

IRS management considers reviews of GITCAs and TRDAs the highest priority work in the NTRCP and believes that concentrating on the renewal of these agreements allows them to reach and maintain compliance for a large number of employers and their employees all at once. However, rate reviews for casino GITCA agreements are the most time-consuming work for the NTRCP because they expire every three years. Full rate reviews must be performed by NTRCP revenue agents when new GITCA or TRDA agreements are established, when renewing existing agreements, or when there are changes in the business ownership. The reason is that there are specific tip reporting rates for the many different occupations in the establishments that must be determined by reviewing historical records. For example, rate reviews for food and beverage occupations such as cocktail servers, bartenders, food servers, and bus persons includes reviewing financial data, point-of-sale data, payroll records, and other related information, such as Forms 8027. For other tipped occupations, the computations are based on financial and payroll data and on other supporting operational data such as parking tickets for valets and room occupancy/bell runs for bellhop departments. However, many times, the time-consuming rate



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review calculations result in tip rates that are the same or reduced. As such, IRS management is using their limited field resources to work on lower risk GITCA agreements instead of higher risk TRACs.

Our review of a random sample of 10 rate reviews (seven GITCAs and three TRDAs) closed in FY 2017 indicates that GITCAs and TRDAs are at lower risk for underreporting of tip income. For *1* of the 10 cases we reviewed, the newly calculated tip rates did not change from the prior agreement. For **1** of the 10 cases, tip rates were reduced by an average of 17 percent.²⁵ NTRCP revenue agents spent more than 500 hours working on these **1** rate reviews for employers and employees that were already complying with the tip agreements. If the rates calculated on renewal agreements are not changing significantly, the compliance impact is much less than what could have been achieved by addressing higher risk noncompliant TRAC taxpayers.²⁶ To help free up resources for higher risk work, the IRS could consider using more extensions for GITCA establishments rather than full rate reviews.

There is an even higher risk of tax noncompliance for employers in tipping industries that do not have a tip agreement. Our analysis of taxpayers' Forms 1120, 1120S, and 1065 for TY 2016 identified 15,771 tip industry employers with \$6.3 billion in projected unreported tip income.²⁷ However, the IRS performed just 34 tip examinations in FY 2016 and 57 in FY 2017. Without employment tax tip examinations on tipping industry taxpayers, the IRS is less likely to bring tip income underreporters into reporting compliance. In addition, there is less incentive for these businesses to establish a tip agreement, because the risk of an audit is very low.

IRS management explained that tip agreements are “alternative treatments to effectively leverage resources and to achieve optimum compliance results and ensure consistency in treatment of SB/SE Division taxpayers.”²⁸ The IRS's focus on GITCAs/TRDAs has likely contributed to their lower compliance risk. Because of the low compliance risk, IRS management stated they have increased the use of tip agreement extensions. IRS management also believes that overall compliance has increased since the implementation of tip agreements and that tax compliance is higher than would be achieved under regular examinations. Regular tip examinations use many of the same techniques to determine underreporting for the establishment and their tipped

²⁵ We randomly selected a sample of 10 rate reviews from a population of 137 rate reviews closed in FY 2017.

²⁶ IRS management explained that rates could be reduced if the calculation included service charges based on Revenue Ruling 2012-18. The Revenue Ruling states (in an example) that where an 18 percent charge is automatically added to a restaurant bill for parties of six or more, the added charge is a service charge, not a tip. However, in the three cases that had rates reduced in our case review, service charges did not affect the rate calculations.

²⁷ We used the same criteria the IRS uses to identify tip industry taxpayers who are potentially underreporting their tip income: *****2*****
*****2*****
*****2***** This calculation is a reasonable estimate, but actual results may vary because gross receipts used for the calculation may also include some income that is not associated with tipping, such as merchandise sales or rentals.

²⁸ IRM 1.1.16.3.1.1(3)(d).



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employees. Management believes these techniques result in achieving optimum compliance, not full compliance. Management also stated that conducting examinations of establishments and the tipped employees are time-consuming and limited by the number of available examiners, which has been historically declining.

Our analysis of 262 tip examination cases closed from FY 2013 to FY 2017 showed that revenue agents, on average, issued a FICA Notice and Demand amount of \$889 per hour worked, compared to the FY 2017 average revenue agent salary cost of \$67 per hour. Over the past four years, the full-time equivalents for revenue agents in the NTRCP has decreased from 19 full-time equivalents in FY 2013 to 17 in FY 2017 (11 percent). In FY 2016, the 23 CETO function tax examiners started assisting the NTRCP with other tip compliance activities, such as soft notices and compliance workstreams. However, the number of IRS employees allocated to oversee tax compliance by tipping industry companies does not appear to be commensurate with the size of the program. Specifically, in FY 2016 the number of employees (41) assigned to the NTRCP represented just 0.46 percent of total IRS examination employees (8,847) even though NTRCP employees are responsible for oversight of an industry that collectively represents 10 percent (\$23 billion) of the TY 2006 estimated individual income tax underreporting Tax Gap. In addition, employees assigned to the general program Specialty Examination function generally do not work cases involving tip income issues even though some of these employees work employment tax examinations and possess the skill sets to work tip income issues. Because so few resources are available, it is essential that NTRCP's significant workload is effectively prioritized.

Recommendations:

The Commissioner, SB/SE Division, should:

Recommendation 1: Use a risk-based approach to more effectively prioritize the use of Field Examination resources for the NTRCP. The risk-based approach should prioritize higher risk work with the greatest impact to tip reporting compliance.

Management's Response: IRS management agreed with this recommendation. IRS management will review the current process to determine whether improvements are needed for identifying higher risk work with the greatest impact to tip reporting compliance.

Recommendation 2: Ensure that NTRCP examiners consider extending the renewal term for employers with GITCAs when annual monitoring indicates they are compliant with payment and reporting compliance so that resources can be used for higher risk work.

Management's Response: IRS management agreed with this recommendation. IRS management will issue an Interim Guidance Memo regarding the option of extending the renewal term, as appropriate, when employers with GITCAs are compliant with payment and reporting requirements.



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Recommendation 3: Use data analysis and sampling to monitor tip agreement compliance and identify taxpayers that need a compliance review. For example, the IRS could focus on the tip agreements with projected unreported tips with a high dollar value.

Management's Response: IRS management agreed with this recommendation. IRS management will review the current process to determine whether improvements can be made to the data analysis and sampling techniques to monitor tip agreement compliance and identify taxpayers that need a compliance review.

Tip Examination Case Selection Is Not Based on Risk Factors

The IRS's primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance on the part of taxpayers. This goal requires the use of professional judgment in selecting sufficient returns that indicate a probability of substantial error while making the most efficient use of examination staffing and other resources.²⁹

Employment tax tip examinations are initiated when it is determined that an employer without a tip agreement is reporting low or zero tips on its Form 941 and tipping is customary in the employer's industry. On June 17, 2002, the Supreme Court rendered a decision in favor of the IRS in *Fior D'Italia, Inc. v. U.S.* The Court held that the IRS has the authority to decide how to calculate and make an assessment of a taxpayer's FICA tax liability on tips received by its employees as long as the method used to make the estimate is not unreasonable. Based on this ruling, the IRS may generally conduct tip examinations and make assessments for Social Security and Medicare taxes on employers only, using a reasonable methodology, without first examining the tip records of the individual employees. The additional tax liability may be based upon the employer's records for the tax year and/or on Forms 4137 filed by employees. The additional tax liability is not due until the IRS issues a Notice and Demand letter. The I.R.C. § 3121(q) FICA tax liability is treated as a current tax liability, and the employer is to report it on a current period Form 941 as instructed in the letter. If the liability is not included on the appropriate Form 941, the IRS may initiate an examination.

The NTRCP has not been using classification processes to identify the highest risk taxpayers for tip examinations since FY 2013. IRS management explained, that due to limited resources, one NTRCP analyst has been responsible for identifying and classifying tip examination cases in the last few years. The analyst manually searches for tip examination cases by using a combination of internet-based searches of public records and ad-hoc queries of IRS systems with the following criteria:

- *****2*****
*****2*****.³⁰

²⁹ Policy Statement 4-21, *Selection of Returns for Examination*.

³⁰ See Appendix VI *****2*****



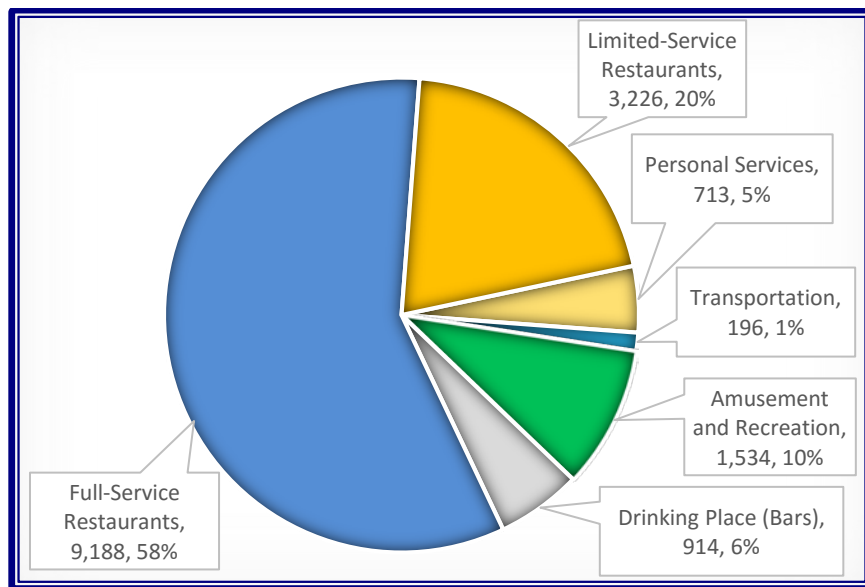
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- *****2*****.
- *****2*****
*****2*****
*****2*****

In addition, tip examination referrals from the Large Business and International (LB&I) Division via the Specialist Referral System are sent to the large case groups within the Employment Tax Examination function to be worked.³¹ However, there is no strategic or risk-based approach used by the NTRCP to determine whether the identified or referred cases have the highest potential for unreported tips.

Using the same IRS criteria for identifying tip examination cases, we identified a population of 15,771 business taxpayers with \$6.3 billion in projected unreported tips.³² Figure 6 shows the different industries for the potential cases identified.

Figure 6: Potential Tip Examination Cases by Industry



Source: TIGTA analysis of TY 2016 Business Master File Returns Transaction File data.

³¹ The LB&I Division serves corporations, subchapter S corporations, and partnerships with assets greater than \$10 million. These businesses typically employ large numbers of employees, deal with complicated issues involving tax law and accounting principles, and conduct business in an expanding global environment.

³² We used only *****2***** for our analysis. This calculation is a reasonable estimate, but actual results may vary because gross receipts used for the calculation may also include some income that is not associated with tipping, such as merchandise sales or rentals.

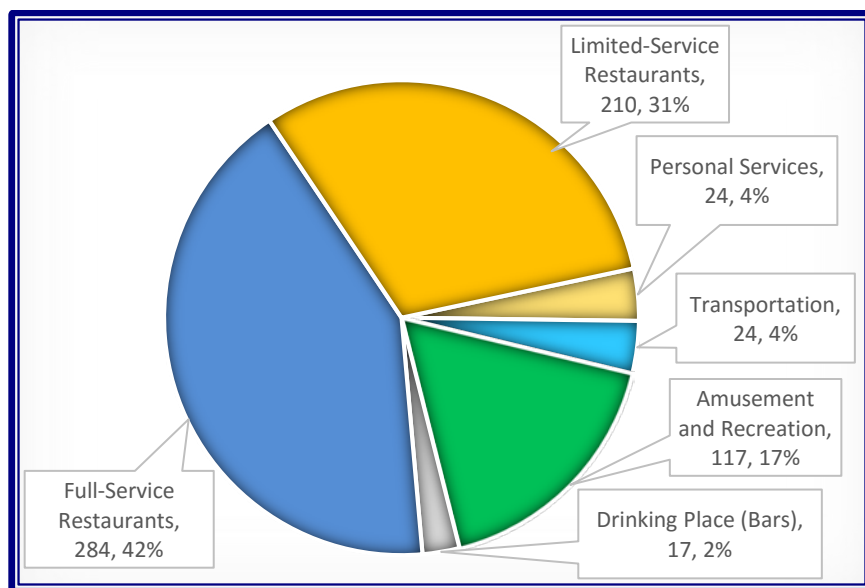


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Full-service restaurants and limited-service restaurants make up 79 percent (12,414) of the potential tip examinations and account for \$4.8 billion (76 percent) of the \$6.3 billion in projected unreported tips. Amusement and recreation (including golf courses, skiing facilities, marinas, and fitness) make up 10 percent (1,534) of the potential tip examinations and account for \$838 million (13 percent) of the \$6.3 billion in projected unreported tips.

We filtered the population further to identify higher dollar cases and identified 676 (4 percent) of the 15,771 potential tip examination cases that had projected unreported tips of over \$1 million, which accounted for nearly \$2.2 billion of projected unreported tips. Figure 7 shows the different industries for the potential high-dollar cases identified.

Figure 7: Potential High-Dollar Tip Examination Cases by Industry



Source: TIGTA analysis of TY 2016 Business Master File Returns Transaction File data.

Full-service restaurants and limited-service restaurants make up 73 percent (494 cases) of the potential tip examinations and account for \$1.6 billion (73 percent) of the \$2.2 billion in projected unreported tips. Amusement and recreation (including golf courses, skiing facilities, marinas, and fitness) make up 17 percent (117 cases) of the potential tip examinations and account for \$384 million (17 percent) of the \$2.2 billion in projected unreported tips. Since some of the gross income for these businesses is due to income that does not produce tips, such as merchandise sales or rentals, we used IRS-provided data to adjust the amount of projected unreported tips to \$1.1 billion. As such, six of the 676 cases were removed.³³ We estimate that,

³³ See Appendix IV for details on these adjustments.

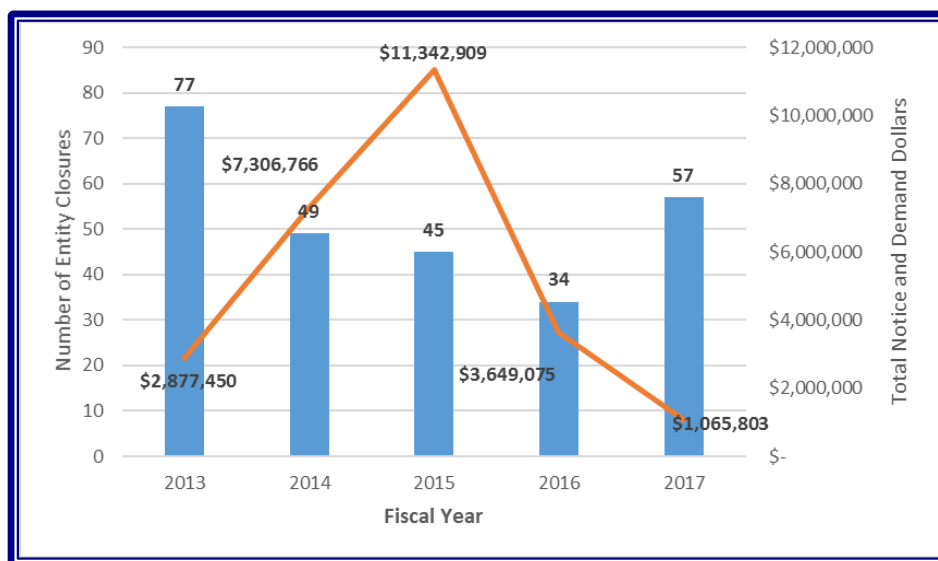


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if the NTRCP worked the remaining 670 cases, it would result in potential increased FICA tax revenue of \$86,729,290.³⁴

NTRCP closed tip examinations over the last five fiscal years show mixed results. Figure 8 shows all NTRCP tip examination closures and the total I.R.C. § 3121(q) FICA tax that resulted from the tip examination adjustments for FYs 2013 through 2017.

Figure 8: NTRCP Overall Tip Examination Closure Results



Source: TIGTA analysis of IRS FYs 2013–2017 closed tip examinations.

The NTRCP has limited resources to work cases, and there is not a consistent trend regarding the compliance outcomes in cases closed with an I.R.C. § 3121(q) Notice and Demand amount. Over the past five years, the average adjustment per case each year ranged from \$37,369 in FY 2013 to \$252,065 in FY 2015, with considerable variance each year. The average adjustment for a case closed during FY 2015 was 1,348 percent higher than a case closed during FY 2017. Meanwhile, during the same period, average adjustments for closed cases in the IRS's overall employment tax examinations varied by no more than a 164 percent.

In addition, the tip examination results include both SB/SE and LB&I Division cases manually selected by the NTRCP analyst. The LB&I Division taxpayers generally result in higher dollar adjustments. Based on the results, there is potential for the NTRCP to identify more high-dollar LB&I Division cases using a risk-based approach.

Figure 9 shows how many closed tip examinations were LB&I Division cases and the percentage of the total I.R.C. § 3121(q) FICA tax adjustments they represented for FYs 2013 through 2017.

³⁴ Six of the 676 cases involved businesses that would *****2*****
*****2*****



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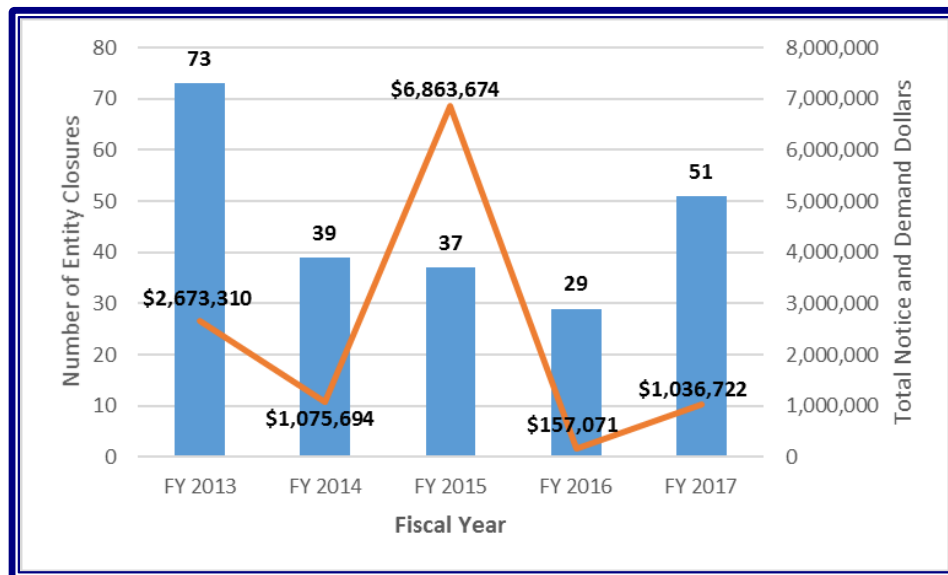
Figure 9: NTRCP LB&I Division Tip Examination Closure Results

Fiscal Year	NTRCP LB&I Cases Closed	Total NTRCP Cases Closed	Percentage of LB&I Cases Closed	Total FICA Tax Adjustment for LB&I Cases	Total FICA Tax Adjustment for All NTRCP Cases	Percentage of FICA Tax Adjustment for LB&I Cases
2013	4	77	5%	\$204,140	\$2,877,450	7.09%
2014	10	49	20%	\$6,231,072	\$7,306,766	85.28%
2015	8	45	18%	\$4,479,235	\$11,342,909	39.49%
2016	5	34	15%	\$3,492,004	\$3,649,075	95.70%
2017	6	57	11%	\$29,081	\$1,065,803	2.73%

Source: TIGTA analysis of FYs 2013–2017 closed tip examination inventory.

In FY 2014, LB&I Division cases represented 20 percent of the total tip examination closures; however, they accounted for 85 percent of the total FICA tax adjustment. In FY 2016, LB&I Division cases represented 15 percent of the total tip examination closures and accounted for 96 percent of the total FICA tax adjustment. When LB&I Division referral closures are removed from the total, the NTRCP tip examination results have more variance. Figure 10 shows the NTRCP SB/SE Division tip examination closures and the total I.R.C. § 3121(q) FICA tax that resulted from the tip examination adjustments for FYs 2013 through 2017.

Figure 10: NTRCP SB/SE Division Tip Examination Closures



Source: TIGTA analysis of IRS FYs 2013–2017 closed tip examinations.

The results of the SB/SE Division tip examination case closures do not have any consistent trends either. Another indicator that higher risk cases are not being selected for tip examinations



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is the no-change rate. The average no-change rate for tip examination cases during the same time period was 31 percent compared to 15 percent for overall employment tax examinations.

Figure 11 shows the average dollars per closure for the manually selected SB/SE Division cases and LB&I Division referral cases by fiscal year.³⁵

Figure 11: FICA Notice and Demand Average Dollars Per Case

Fiscal Year	SB/SE Division Closures	SB/SE Division Average Dollars Per Closure	LB&I Division Closures	LB&I Division Average Dollars Per Closure
2013	73	\$36,621	4	\$51,035
2014	39	\$27,582	10	\$623,107
2015	37	\$185,505	8	\$559,904
2016	29	\$5,416	5	\$698,401
2017	51	\$20,328	6	\$4,847
Average	46	\$51,557	7	\$437,440

Source: TIGTA analysis of FYs 2013–2017 closed tip examinations.

The overall average dollars per LB&I Division closure (\$437,440) is over eight times more than the overall average dollars per SB/SE Division closure (\$51,557) for FYs 2013 through 2017.

IRS management agreed that the tip examination case selection process needs improvement and stated that the NTRCP is working with the Exam Case Selection (ECS) function to improve the selection process and ensure that the fairness standard is met.

Recommendation:

Recommendation 4: The Commissioner, SB/SE Division, should develop a risk-based case selection methodology using historical statistics and data analysis to identify the highest risk tip examination cases on an annual basis. For example, the IRS could focus on taxpayers with projected unreported tips in a high-dollar value. The cases could then be classified based on the updated prioritization of Field resources available for tip examinations.

Management's Response: IRS management agreed with this recommendation. IRS management will review the current process to determine whether improvements are needed for identifying higher risk tip examinations taking into consideration historical statistics and annual data analysis. However, management disagreed with the related

³⁵ The average dollars for all fiscal years was calculated by totaling the dollars by Division for all fiscal years and then dividing it by the total closures by Division for all fiscal years.



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outcome measure, stating that it does not account for revenues that would be lost from diverting resources from other Examination programs.

Office of Audit Comment: The purpose of our outcome measure is to inform stakeholders of the size and scope of the issue. Our outcome measure reflects the potential increased FICA tax revenue if the IRS examined the taxpayers TIGTA identified. In addition, IRS management made suggested changes to the outcome measure computation during the audit, which we used for the calculations.

Employer Federal Insurance Contributions Act Taxes Are Not Always Assessed After Tip Examinations Identify Unreported Tip Income

When an employer tip examination reveals underreporting of tip income, the IRS issues a Notice and Demand letter that instructs the employer in which quarter and on which line to report the amount of FICA taxes due on unreported tips on Form 941.³⁶ IRS policy requires the examiner to monitor the taxpayer's Form 941 filings to ensure that the taxpayer reports and pays the amount due. If the taxpayer does not report the tax correctly, the examiner should make contact to get the taxpayer to comply by filing a Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*. If the taxpayer does not comply, the examiner should open a limited scope examination to assess the amount of FICA tax that is owed.³⁷

Our review of the 34 tip examinations closed in FY 2016 determined that for three (9 percent) cases the employer did not comply with the Notice and Demand letter and the IRS did not follow through to open a limited scope examination to assess the tax due. IRS management told us that the cases showed collectability concerns and therefore a managerial decision was made to discontinue the Notice and Demand letter follow-up process. However, IRS procedures require examiners to consider collectability of the taxpayer during the preaudit phase and throughout the examination and to limit the scope of the examination if there is no current or future collectability potential. In all three instances, even though the examiners documented that the cases had collectability concerns, examiners continued to work the cases and issued the Notice and Demand letter.

Our additional analysis of the tip examination data for 195 cases (closed from FYs 2012 through 2015) in which the taxpayer was issued a Notice and Demand letter for unreported tip income and FICA tax owed showed that in 20 (10 percent) cases there was no clear evidence that the taxpayer complied with the letter. In addition, the IRS did not follow through to open a limited

³⁶ I.R.C. § 3121(q) provides that employers must pay the employer's share of Social Security and Medicare taxes on tips reported by their employees in the course of employment. See Appendix V for a copy of the I.R.C. § 3121(q) Notice and Demand letter (Letter 3263-E).

³⁷ IRM 4.23.7.7.4(16)c (Dec. 18, 2012).



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scope examination to assess the FICA tax due on these cases. The I.R.C. § 3121(q) FICA tax adjustment on these 20 cases was \$1.9 million.

IRS management responded that without reviewing the actual paper case files for these 20 cases, they could not conclusively say whether the taxpayer complied with the Notice and Demand letter or why the IRS did not follow through to assess the tax due. For eight of the 20 cases, the IRS said there were indicators that the I.R.C. § 3121(q) amount was not pursued for other reasons, such as collectability factors.

The IRS could continue the follow-up Notice and Demand letter process on tip examination cases without using limited Field Examination resources by assigning the cases to tax examiners in the NTRCP's CETO function. These tax examiners already perform the Notice and Demand letter follow-up process when working Form 4137 Matching cases.³⁸ The NTRCP is expending its limited Field Examination resources to examine taxpayers for unreported tips but is not following through on the Notice and Demand letter process to ensure that the FICA tax owed is assessed.

Examiners do not always pick up prior/subsequent years for audit when warranted

IRS procedures require examiners to conduct the employment tax examination to a point in which the reported tax liability is determined to be substantially correct and to expand the examination to include prior and subsequent years if the issue under development is material and recurring.³⁹ In addition, all reasons for limiting the scope should be fully documented.⁴⁰

Our review of the population of 34 tip examination cases closed in FY 2016 identified four (12 percent) cases in which the examiner did not pick up the prior or subsequent tax years for audit when warranted. IRS management disagreed with TIGTA that expansion was warranted for **1** of these cases. In all four cases, however, TIGTA maintains that the IRS did not conduct the employment tax examination to a point in which the reported tax liability was determined to be substantially correct because the scope was not expanded to include prior and subsequent years. In addition, the underreported tip income for these taxpayers was material and recurring, justifying the need to expand the scope.

³⁸ Form 4137 is filed by individual taxpayers and included with their Form 1040 when reporting tip income that was not originally reported by the employer on their Form W-2, *Wage and Tax Statement*. The ECS function sends these cases to the CETO function to work annually, which consists of sending an I.R.C. § 3121(q) Notice and Demand letter to the employer to report and pay their portion of the employees' FICA tax on the newly reported tip income. CETO function tax examiners open limited scope examinations to assess the FICA tax when employers do not respond to the I.R.C. § 3121(q) Notice and Demand letter—the same process revenue agents use for closed tip examination cases.

³⁹ IRM 4.23.3.6.4.2(5) (Aug. 25, 2016); IRM 4.23.3.6.4.3(5) (Aug. 25, 2016).

⁴⁰ IRM 4.23.3.6.4.3(5) (Aug. 25, 2016).



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Based on our analysis of potential unreported tip income for subsequent tax years in these four cases, we estimate potential increased FICA tax revenue of \$8 million if the IRS audited the subsequent tax returns for these taxpayers.

Recommendations:

The Commissioner, SB/SE Division, should:

Recommendation 5: Use the NTRCP CETO function to complete the Notice and Demand letter process for closed tip examinations when Field Examination resources are limited. The CETO function already performs this work for the Form 4137 tip compliance workstream, so it would not be a new process for them.

Management's Response: IRS management agreed with this recommendation. IRS management will review the current process for working 3121(q) Notice and Demands for closed tip examinations to determine whether CETO resources can be used to supplement Field resources.

Recommendation 6: Update the Tip Examination IRM to clarify the requirements for making a determination and documenting the reasons to expand or limit the scope to prior and/or subsequent years. The documentation should include the use of further analysis to justify the reason for expanding or limiting the scope of the audit to prior/subsequent years.

Management's Response: IRS management agreed with this recommendation. IRS management will issue an Interim Guidance Memorandum to clarify the requirements for making a determination and documenting the reasons to expand or limit the scope to prior and/or subsequent years. It will include the use of further analysis to justify the reason for expanding or limiting the scope of the audit to prior/subsequent years.

Tip Reporting Alternative Commitment Agreements Are Rarely Revoked

When a taxpayer with a tip agreement is not in compliance, revocation of the tip agreement may be necessary so that audit protection can end and a tip examination can begin. The language in the TRAC agreement allows the IRS to revoke the agreement when the employer fails to meet one or more of the commitments. TRAC agreements may be revoked if the employer fails to:

- 1) Establish and maintain a quarterly employee educational program for tip reporting.
- 2) Establish and implement monthly employee tip reporting procedures.
- 3) Comply with filing, deposit, and payment requirements for Form 941; Form W-2, *Wage and Tax Statement*; and other required returns to include maintaining records for gross receipts subject to tipping and charged tip receipts.



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TRAC agreements prior to the most recent revision (September 2004) also allowed revocation if employees of the establishment collectively and substantially underreported tip income for at least two consecutive quarters. Despite the clear language of the expectations of employers and consequences of noncompliance, revocation of tip agreements is rare. Since FY 2013, the IRS has revoked just 13 tip agreements even though we identified 1,971 tip agreement employers with projected unreported tips of nearly \$1.66 billion. All 13 of the tip agreements were revoked in FY 2013 and all were TRDAs; no tip agreements have been revoked since then.

Our review of the 10 most recently completed tip agreement compliance reviews showed that revenue agents had documented at least one reason to revoke the agreement in *1* cases.⁴¹ The most common reason to revoke was employee underreporting of tips for at least two consecutive quarters (six cases), followed by employer failure to meet the reporting procedures commitment (four cases). Projected unreported tip income in these **1** cases totaled \$114 million.

In order for a tip agreement to be revoked, a compliance review must be completed. As previously discussed, the IRS has completed only 17 compliance reviews over the past four years. In addition, even when a compliance review identifies noncompliance, the IRS's policy for revocation of a tip agreement makes it difficult to revoke. Specifically, if a compliance review determines the employer is not in compliance with the commitments made in the agreement, the IRS generally allows the employer two quarters to get into compliance.⁴² The IRS must then perform a follow-up compliance review to make the compliance determination again before attempting to revoke the agreement. If the employer is still not in compliance after the follow-up review, three parties are required to approve revocation of the TRAC agreement, including the NTRCP Program Manager, Specialty Examination Chief, and another IRS executive.

In addition, revenue agents did not always address the results of the substantial unreported tips as shown on the Form 8027 analysis with the employer. In three of the 10 cases we reviewed, we did not find evidence the revenue agent sent the employer a compliance review closing letter with an attached Form 14354, *Summary of Compliance Review Findings and Recommendations*, to inform the employer of the substantially unreported tips and low cash tip rates shown on the Form 8027 analysis. *****1*****
*****1*****. The total projected unreported tips for these cases was \$29.9 million.

If the tip agreements for these taxpayers were revoked, the employer would not continue to get audit protection and the IRS could issue a Notice and Demand letter during a future tip examination if the employer continued to underreport tips. One reason for these problems could be that IRS procedures for compliance reviews are vague and do not give any details on what is required in the compliance review. The IRS Employment Tax Tip/Gaming Training guide does

⁴¹ Cases can have multiple justifications for revocation.

⁴² IRM 4.23.7.10.4.1(3) (Dec. 18, 2012).



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give more detail on what is required to be done during a compliance review, but it is not incorporated into the IRM. In fact, the tip examination section of the IRM states, “If you receive a case for a compliance review, contact the NTRCP Policy Analyst for details on these procedures.”

IRS management stated they understand the conclusions we reached on the ****1**** TRAC compliance reviews, but without discussions with the examiner and manager, they could not determine whether our conclusions were correct. Specifically, seven of the ****1**** compliance reviews were conducted prior to the centralization of the tip program under the NTRCP in FY 2015, and management believes the case file documentation is insufficient to explain all of the steps that were taken. IRS management stated there are often facts and circumstances that lead to extending the tip agreements to gain increased future compliance.

Tip agreements with noncompliant employers are not beneficial to tax administration. The noncompliant employer enjoys the benefit of tip audit protection even when noncompliant behavior is identified. Failure to hold employers accountable for noncompliance negatively affects the NTRCP goal to help employees accurately report their tip income and employers to meet their filing and reporting obligations. In addition, the IRS’s tolerance of noncompliance is not fair to the employers who fully comply with the terms of their agreements.

Recommendations:

The Commissioner, SB/SE Division, should:

Recommendation 7: Consider reducing the number of approvals necessary to revoke tip agreements with noncompliant employers.

Management’s Response: IRS management agreed with this recommendation. IRS management will review the delegation order for revoking tip agreements to determine whether any revisions are needed.

Recommendation 8: Update the IRM to provide more specific criteria and examples of when to revoke a tip agreement if an establishment is substantially noncompliant with the commitments of the agreement and to provide more specific criteria and examples on how to perform compliance reviews, including the Form 8027 analysis of unreported tips. Provide employee training on the changes to the IRM.

Management’s Response: IRS management agreed with this recommendation. IRS management will issue an Interim Guidance Memorandum to provide more specific criteria and examples of when to revoke a tip agreement if an establishment is substantially noncompliant with the commitments of the agreement and to provide more specific criteria and examples on how to perform compliance reviews, including the Form 8027 analysis of unreported tips. Training workshops will be delivered to ensure that employees understand and implement the Interim Guidance Memo.



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Tax Exempt and Government Entities Division Form 4137 Compliance Cases Are Not Being Worked

In August 2014, 40 employees, consisting of tax examiners, managers, and administrative support staff, were realigned from the Bank Secrecy Act Examination function to the Employment Tax Examination function to form the CETO group. The group was formed to assist the NTRCP in addressing tip reporting compliance activities that had not been performed previously or were underutilized due to a lack of resources. Types of work the CETO function performs includes: Form 4137 Compliance, Form 8027 Non-Filer Soft Notices, Unreported Tip Income Soft Notices, and Form 941/944 Mismatch.

IRS management believes that one of the most valuable compliance activities performed by CETO function tax examiners is Form 4137 Compliance work. Form 4137 Compliance closures have increased by 225 percent and FICA Notice and Demand dollars have increased 32 percent between FYs 2014 and 2017. Individuals are required to file Form 4137 with their Form 1040 tax return to report and pay their portion of the FICA tax for any tip income that was not originally reported on their Form W-2. On a biannual basis, the ECS function aggregates the Form 4137 filings to identify the related employers and ranks the cases by the highest underreported tip income.⁴³ The NTRCP then issues a Notice and Demand letter to the employers to report and pay their portion of the FICA tax on the newly reported tip income.⁴⁴ CETO function tax examiners work the taxpayer responses for these notices and monitor the cases to ensure that employers file and pay. If employers fail to file and pay, CETO function tax examiners are required to open limited scope examinations to assess the FICA tax owed.⁴⁵

However, we determined that the NTRCP is not required to work Tax Exempt and Government Entities (TE/GE) Division Form 4137 Compliance cases, and the cases had not been worked by the TE/GE Division either. ECS function employees advised us that TE/GE Division Form 4137 Compliance cases were first identified during the aggregation process in April 2015. The ECS function identified 176 TE/GE Division Form 4137 cases for TYs 2013, 2014, and 2015. IRS management confirmed the TE/GE Division has not worked Form 4137 Compliance cases in the past due to resource issues.

If the IRS does not work TE/GE Division Form 4137 Compliance cases, the employers will not report and pay their portion of the FICA tax on the employee's additional tip income reported on the Form 4137, resulting in a loss of FICA tax revenue. Based on the data provided for these cases, more than \$5 million of tip income each Tax Year (2013 through 2015) was potentially not reported by these TE/GE Division employers when a Notice and Demand letter was not issued. If the IRS worked these cases, we estimate a potential increased FICA tax revenue of

⁴³ IRM 4.23.7.4.1(2) (Jan. 18, 2012).

⁴⁴ IRM 4.23.7.4.1(4) (Jan. 18, 2012).

⁴⁵ IRM 4.23.7.4.1(12) (Jan. 18, 2012).



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

\$547,625 for TY 2013, \$538,789 for TY 2014, and \$431,849 for TY 2015, totaling \$1,518,264 for all three tax years.⁴⁶

After we brought this matter to the IRS's attention, IRS management informed us that the SB/SE Division NTRCP now has a current agreement with the TE/GE Division's Indian and Tribal Government group for the SB/SE Division NTRCP CETO function to work Form 4137 Compliance cases starting with TY 2016. The SB/SE Division is currently working the cases.

Recommendation:

Recommendation 9: The Commissioners, SB/SE and TE/GE Divisions, should ensure that Form 4137 Compliance cases are addressed in the CETO function's annual work plans, including the TY 2013 through 2015 cases, which involved more than \$1.5 million in potential increased FICA tax revenue.

Management's Response: IRS management agreed with this recommendation. IRS management stated that SB/SE Division filters used to identify higher risk FY 2016 TE/GE Division Indian Tribal Government Form 4137 compliance cases will be applied to the FY 2013 through 2015 TE/GE Division Indian Tribal Government Form 4137 Compliance cases. The TE/GE Division Indian Tribal Government higher risk cases will be included in the SB/SE Division CETO work plan as resources permit. However, IRS management disagreed with the related outcome measure, stating it does not account for revenues that would be lost from diverting resources from other Examination programs.

Office of Audit Comment: The purpose of our outcome measure is to inform stakeholders of the size and scope of the issue. Our outcome measure reflects the potential increased tax revenue if the IRS worked the additional Form 4137 Compliance cases that TIGTA identified. In addition, IRS management made suggested changes to the outcome measure computation during the audit, which we used for the calculations.

⁴⁶ We calculated the FICA tax owed by multiplying unreported tip income by 7.65 percent for the three tax years.



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

Appendix I

Detailed Objectives, Scope, and Methodology

The objective of this review was to determine whether the IRS is using the NTRCP to provide balanced and adequate reporting compliance oversight of taxpayers in industries in which tipping is customary.¹ To accomplish the objective, we:

- I. Identified NTRCP IRM procedures, guidelines, internal controls, and training requirements, including the tip examination process and the CETO function compliance processes, to gain an overall understanding of the program.
 - A. Reviewed the IRM procedures and guidelines used for tip agreements, employment tax tip examinations, and the Notice and Demand letter process.
 - B. Conducted two site visits and met with and interviewed:
 1. NTRCP tip agreement coordinators in Detroit, Michigan, and Las Vegas, Nevada, to obtain an understanding of how tip agreements are designed, solicited, and monitored and how rate reviews, addendum reviews, and compliance reviews of tip agreements are conducted.
 2. The group manager and revenue agents from the SB/SE Division Specialty Examination function's Employment Tax program in Las Vegas, Nevada, to obtain an understanding of how cases are prioritized and selected for tip examinations and how examinations are conducted.
 3. The Territory Manager, a revenue agent, and CETO function management and staff in the IRS Detroit, Michigan, office to walk through and obtain an understanding of the NTRCP compliance processes and work performed by the CETO function.
- II. Determined how IRS management measures and monitors the NTRCP.
 - A. Obtained, analyzed, and discussed with IRS management how the data/reports are used to monitor the program.
 1. Identified and reviewed the current mission, measures, goals, and work plan of the NTRCP.
 2. Discussed with IRS management how and when management establishes and takes action to revise NTRCP work plan goals and measures.

¹ See Appendix VII for a glossary of terms.



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

- III. Determined whether tip agreement monitoring, rate reviews, and compliance reviews are conducted timely and sufficiently and if taxpayers are in compliance.
- A. Obtained from the IRS a list of FYs 2013 through 2017 closed tip agreement rate reviews, addendum reviews, and compliance reviews worked by the NTRCP revenue agents.
1. Analyzed the listing to identify trends, such as number of cases closures and hours worked for each workstream. Compared the trends to the same criteria the IRS uses for potential tip examinations (step IV.A).
- B. Determined whether the population of taxpayers with tip agreements appeared to comply with tip reporting by using the IRS criteria for identifying taxpayers for potential tip examinations.
1. Obtained a list of current tip compliance agreements from the IRS.
2. Identified 6,513 employer taxpayers with tip agreements that filed a business tax return (Form 1120, *U.S. Corporation Income Tax Return*; Form 1120S, *U.S. Income Tax Return for an S Corporation*; or Form 1065, *U.S. Return of Partnership Income*) for TY 2016 by extracting the data using the TIGTA Data Center Warehouse's Business Returns Transaction File.
3. Calculated the projected unreported tips for the 6,513 employer taxpayers by
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4. Analyzed the 1,971 employer taxpayers to identify trends, such as the different types of tip industries and tip compliance agreements, and those taxpayers with projected unreported tips over \$1 million.
- C. Selected a random sample of 10 tip agreement rate reviews from a population of 137 rate reviews closed in FY 2017 and the 10 most current compliance review cases from a population of 53 compliance reviews closed from FY 2013 through FY 2017. Random samples were used for the tip agreement rate review population to ensure

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Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

that each case had an equal chance of being selected. A judgmental sample was used for the compliance review population to obtain the most currently closed cases.³

1. Reviewed the rate review and compliance review sample cases to determine if examiners followed IRS procedures.
2. Compared the newly calculated tip rates for the rate review to the prior tip agreement tip rates.

IV. Evaluated the employer tip examination portion of the program to determine how the IRS selects cases for tip examinations, whether examiners are properly following tip examination procedures, and if sufficient audit coverage is being performed across the tipping industries.

A. Determined how the IRS identifies the population of potential employer tip examination cases and how cases are selected for assignment.

1. Identified and discussed criteria used by the ECS function to select and produce inventory for field tip examinations with IRS management. *****2*****
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2. Discussed how NTRCP analysts perform additional data analysis and work with the ECS function to identify the potential tip examination workload.
3. Identified a population of 15,771 potential tip examination cases using the IRS criteria for identifying tip examinations (Step IV.A.1).⁵
 - a) Used the TIGTA Data Center Warehouse's Business Returns Transaction File data to identify those taxpayers that reported FY 2016 *****2*****
*****2*****on Forms 1120, 1120S, or 1065 and reported FY 2016 Form 941, *Employer's Quarterly Federal Tax Return*, tip income equal to 1 percent or more of gross receipts.⁶
 - b) Calculated the projected unreported tips by *****2*****
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³ A judgmental sample is a nonprobability sample, the results of which cannot be projected to the population.

⁴ *****2*****.

⁵ *****2*****
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⁶ We eliminated those taxpayers for which the reported FY 2016 Form 941 tip income was less than 1 percent of reported FY 2016 gross receipts because it may indicate the company uses a Professional Employer Organization to process their payroll taxes. In these cases, the Form 941 tip income may be reported under the Professional Employer Organization or a related Taxpayer Identification Number.



*Billions in Tip-Related Tax Noncompliance Are Not Fully
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- c) Analyzed the 15,771 taxpayers to identify trends, such as the different types of tip industries and those taxpayers with projected unreported tips over \$1 million.
- d) Calculated the potential amount of increased revenue if additional tip examinations were conducted for those taxpayers with projected unreported tips over \$1 million by multiplying the projected unreported tips by 7.65 percent (employer portion of the FICA tax).

B. Determined whether revenue agents properly conducted tip examinations.

- 1. Identified a population of 34 employer tip examination cases closed in FY 2016 by using the TIGTA Data Center Warehouse's Audit Information Management System closed case data file to identify the population of tip examination cases with Project Code 0673 and Activity Code 465.
 - a) Ordered examination case files and tax returns for the FY 2016 closed cases (34 cases).
 - b) Reviewed the 34 FY 2016 cases to determine whether examiners followed IRM procedures when working the tip examinations, including the Notice and Demand letter follow-up process required by examiners for examinations that result in tip income adjustments.
- 2. Identified a population of 195 employer tip examination cases closed from FY 2012 to FY 2015 in which the examination resulted in unreported tip income and the taxpayer was issued a Notice and Demand letter with a FICA tax due amount greater than zero.
 - a) Obtained Form 941 tax return data, transaction code data, and project code data for the 195 taxpayers by extracting the data from the TIGTA Data Center Warehouse's Business Returns Transaction File, Business Master File, and Audit Information Management System files.
 - b) Analyzed the data and used Integrated Data Retrieval System transaction data, as needed, to look for evidence that the taxpayer reported the FICA tax due on the tip income adjustment or that the examiner followed up to assess the tax due if the taxpayer did not report it, as required by IRS procedures.

V. Determined how the CETO function works with the NTRCP to accomplish tip reporting compliance goals.

- A. Obtained and reviewed the CETO function's FYs 2016 and 2017 work plans and management reports with closed case statistics.



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

- B. Discussed with IRS management where each workstream falls in the CETO function's work plan goals, how workstream goals are determined, and how resources are distributed.
 - C. Calculated the potential amount of increased FICA tax revenue if the NTRCP worked TE/GE Division Form 4137 cases identified by the ECS function for TYs 2013, 2014, and 2015.
- VI. Validated the data obtained from the TIGTA Data Center Warehouse for the populations identified in steps III.B.2, III.C, IV.A.3, IV.B.1, and IV.B.2.
- A. Validated the data extracts by selecting random samples of 10 cases for each population to verify the accuracy of the data fields needed for our review and analyses. We determined that the data were reasonable, complete, and accurate and, therefore, sufficiently reliable for the audit purpose.
 - B. Completed a Record of Data Reliability Assessment for each population to document the data validation.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the IRS procedures, policies, and practices for the NTRCP for workload and case selection, processing and monitoring tip agreements; performing tip agreement rate reviews, addendum rate reviews, and compliance reviews; and performing tip income examinations. We evaluated these controls by interviewing management, reviewing IRM procedures and other related guidance, analyzing tip agreement and tip examination data, and performing case reviews.



*Billions in Tip-Related Tax Noncompliance Are Not Fully
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Appendix II

Major Contributors to This Report

Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement
Operations)
Carl Aley, Director
Phyllis Heald London, Audit Manager
Heath Sollak, Lead Auditor
Danielle Marchetta, Auditor



*Billions in Tip-Related Tax Noncompliance Are Not Fully
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Appendix III

Report Distribution List

Deputy Commissioner for Services and Enforcement
Deputy Commissioner, Small Business/Self-Employed Division
Deputy Commissioner, Tax Exempt and Government Entities Division
Director, Examination, Small Business/Self-Employed Division
Director, Government Entities/Shared Services, Tax Exempt and Government Entities Division
Director, Headquarters Examination, Small Business/Self-Employed Division
Director, Specialty Examination, Small Business/Self-Employed Division
Director, Specialty Policy, Small Business/Self-Employed Division
Director, Office of Audit Coordination



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

Increased Revenue – Potential; \$86,729,290 in FICA tax revenue that could potentially be assessed if the IRS examined 670 tip industry businesses with projected unreported tips totaling \$1,133,716,203 (see page 13).¹

Methodology Used to Measure the Reported Benefit:

We identified a population of 676 business taxpayers with projected unreported tips over \$1 million. We calculated projected unreported tips on the 676 cases by *****2*****

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- 3) *****2*****
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¹ See Appendix VII for a glossary of terms.

² This calculation is the same one used by the IRS to determine projected unreported tips when identifying potential tip examination cases.



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

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The total projected unreported tips for the 670 remaining cases after adjustments is \$1,133,716,203. We then multiplied the employer portion of the FICA tax owed (7.65 percent) by the total projected unreported tip income. We estimate based on these data that, if the IRS examined the 670 business taxpayers for tip income, it would potentially increase FICA tax revenue by \$86,729,290.

Type and Value of Outcome Measure:

Increased Revenue – Potential; \$1,518,264 in FICA tax revenue that could potentially be assessed if the IRS worked 176 TE/GE Division Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*, cases with employee reported tip income of \$19,846,586 not previously reported by the employers (see page 24).

Methodology Used to Measure the Reported Benefit:

We identified a population of 176 TE/GE Division Form 4137 cases for TYs 2013, 2014, and 2015 for which individual employee taxpayers reported tip income totaling \$19,846,586 not previously reported to their employers and for which the IRS did not issue a Notice and Demand letter to the employers. We multiplied the employer portion of the FICA tax owed (7.65 percent) by employee reported income of \$19,846,586. We estimate based on these data that, if the IRS worked these 176 TE/GE Form 4137 cases, it would potentially increase FICA tax revenue by \$1,518,264.



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Appendix V

Notice and Demand Under Section 3121(q)



Department of the Treasury
Internal Revenue Service
[Operating Division / Program Name]

Date:
05/02/2018
Employer ID number (last 4 digits):

Form:

Tax year(s) ended:

Person to contact:

Employee ID number:

Contact telephone number:

Contact fax number:

Notice and Demand under Section 3121(q)

Date of Notice and Demand:

Dear:

We received information from you regarding tips reported by your employees. Based on that information and our inspection of your books and records, we've determined that you owe additional social security and Medicare tax on unreported tips of \$0.00 for tax year(s) shown above.

This letter is your **Notice and Demand** for payment of social security and Medicare taxes on these unreported tips, as required by Internal Revenue Code section 3121(q).

The tax due on the unreported tips is \$0.00 (see the enclosed calculation). Deposit the tax within the time period required under your depository rules to avoid any possible deposit penalty. If you use a payroll service, you should notify them immediately.

Report this tax on the line titled "Section 3121(q) Notice and Demand - Tax due on unreported tips" on Form 941, *Employer's QUARTERLY Federal Tax Return*, for the calendar quarter corresponding to the **Date of Notice and Demand** shown above.

Please contact the person whose name and telephone number are shown above if you have questions about this letter.

Sincerely,

[Name]
[Title]

Enclosures:
Tax Calculation

Letter 3263-E (Rev. 1-2016)
Catalog Number 52715G



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Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

Appendix VII

Glossary of Terms

Term	Definition
Audit Information Management System	A computer system used by the Small Business/Self-Employed Division Examination Operations function and others to control returns, input assessments/adjustments to the Master File, and provide management reports.
Business Master File	The IRS database that maintains transactions or records of business tax accounts.
Returns Transaction File	The IRS database that consists of tax-related data captured when taxpayers file tax returns, such as business returns filed on Form 1120, <i>U.S. Corporation Income Tax Return</i> ; Form 1120S, <i>U.S. Income Tax Return for an S Corporation</i> ; and Form 1065, <i>U.S. Return of Partnership Income</i> and various supporting schedules.
Campus	The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
Federal Insurance Contributions Act (FICA)	The taxes under the FICA are Social Security taxes and Medicare taxes (including Additional Medicare Tax). Social Security taxes pay for benefits under the old age, survivors, and disability insurance part of the FICA. Medicare taxes pay for hospital benefits. Each employee contributes part of these taxes and the employer pays a matching amount. Self-employed taxpayers must also pay Social Security and Medicare taxes in the form of self-employment taxes.
Federal Unemployment Tax Act	The Federal Unemployment Tax Act, with State unemployment systems, provides for payments of unemployment compensation to workers who have lost their jobs. Most employers pay both a Federal and a State unemployment tax.
Fiscal Year	Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
Form W-2, Wage and Tax Statement	Used to report employee wages earned and taxes withheld.



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

Term	Definition
Form 941, Employer's QUARTERLY Federal Tax Return	Used to report the employer's portion of FICA taxes on wages earned by employees.
Form 1040, U.S. Individual Income Tax Return	Used to report an individual's taxable income.
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Individual Income Tax Underreporting Tax Gap	The individual income tax underreporting Tax Gap is the amount of tax liability not voluntarily reported by individual taxpayers who file required returns on time.
Integrated Data Retrieval System	IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
Internal Revenue Code	Title 26 of the United States Code enacted by Congress containing all relevant rules pertaining to estate, excise, gift, income, payroll, and sales taxes.
Internal Revenue Manual	The primary, official source of IRS "instructions to staff" relating to the organization, administration, and operation of the IRS. It details the policies, delegations of authorities, procedures, instructions, and guidelines for daily operations for all divisions and functions of the IRS.
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Racino	A racetrack at which slot machines are available for gamblers, <i>i.e.</i> , combined racetrack and casino.
Revenue Agent	Employees in the Examination function who conduct face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (<i>e.g.</i> , excise tax returns).
Tax Year	A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
TIGTA Data Center Warehouse	An online database maintained by TIGTA. The Data Center Warehouse pulls data from IRS system resources, such as IRS Collection files and IRS Examination files, for TIGTA access.



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

Appendix VIII

Management's Response to the Draft Report




COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

September 10, 2018

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Mary Beth Murphy
Commissioner, Small Business/Self-Employed Division 

SUBJECT: Draft Audit Report – Billions in Tip-Related Tax Noncompliance is Not Fully Addressed and Tip Agreements Are Generally Not Enforced (Audit # 201730036)

Thank you for the opportunity to review the above subject draft audit report. In 2006, we estimated that 10 percent of the individual income tax underreporting gap was due to unreported tip income by employees. Tip income is also subject to employment taxes for both the employer and employee.

Our National Tip Reporting Compliance Program (NTRCP) is a voluntary compliance and enforcement program. It is dedicated to helping employees accurately report their tip income and employers meet their filing and reporting obligations. NTRCP uses education, outreach, voluntary tip agreements, examinations and other tools to address underreporting, underpayment and non-filing in businesses where tipping is customary.

As noted in your report, we have limited resources available to address tip compliance. In 2014, we created the Centralized Employment Tax Operations (CETO) to assist with compliance activities that had not been performed previously or were underutilized. Centralization of this work into CETO allowed our NTRCP revenue agents to conduct more complex and technical work. Over the past several years, we have focused our NTRCP revenue agent resources on certain tip agreements which allow us to reach and maintain compliance for a large number of employers and their employees at once. We appreciate your recognition that this focus has likely contributed to lowering risk of non-compliance for those types of tip agreements.

While we have taken these steps to leverage our limited resources, we recognize that more can be done. We plan to use more risk and data analysis in our approach to case selection as well as modify certain procedures to improve our efficiency. We intend to issue guidance on extending renewal terms for tip agreements. We are also going to clarify compliance review procedures and when revocation of tip agreements is appropriate.



*Billions in Tip-Related Tax Noncompliance Are Not Fully
Addressed and Tip Agreements Are Generally Not Enforced*

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We do not agree with the outcome measure of \$86.7 million of Federal Insurance Contributions Act (FICA) tax revenue potentially generated from examining certain tip industry businesses nor do we agree with the outcome measure of \$1.5 million of FICA tax revenue potentially generated from examining certain Tax Exempt/Government Entities Division cases. The outcome measures do not account for revenues that would be lost from diverting resources from other Examination programs.

Attached is a detailed response outlining our corrective actions to address your recommendations. If you have any questions, please contact me or Brenda A. Dial, Director, Examination Operations.

Attachment



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

Attachment

RECOMMENDATION 1:

The Commissioner, Small Business/Self-Employed Division, should use a risk-based approach to more effectively prioritize the use of Field Examination resources for the NTRCP. The risk-based approach should prioritize higher risk work with the greatest impact to tip reporting compliance.

CORRECTIVE ACTION:

We agree with the recommendation. We will review the current process to determine whether improvements are needed for identifying higher risk work with the greatest impact to tip reporting compliance.

IMPLEMENTATION DATE:

January 15, 2020

RESPONSIBLE OFFICIAL:

Director, Specialty Examination, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:

The Commissioner, Small Business/Self-Employed Division, should ensure NTRCP examiners consider extending the renewal term for employers with Gaming Industry Tip Compliance Agreements (GITCA) when annual monitoring indicates they are compliant with payment and reporting compliance, so that resources can be used for higher risk work.

CORRECTIVE ACTION:

We agree with the recommendation. We will issue an Interim Guidance Memorandum (IGM) regarding the option of extending the renewal term, as appropriate, when employers with GITCAs are compliant with payment and reporting requirements.

IMPLEMENTATION DATE:

October 15, 2019

RESPONSIBLE OFFICIAL:

Director, Specialty Examination, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.



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RECOMMENDATION 3:

The Commissioner, Small Business/Self-Employed Division, should use data analysis and sampling to monitor tip agreement compliance and identify taxpayers that need a compliance review. For example, the IRS could focus on the tip agreements with projected unreported tips with a high dollar value.

CORRECTIVE ACTION:

We agree with the recommendation. We will review the current process to determine whether improvements can be made to the data analysis and sampling techniques to monitor tip agreement compliance and identify taxpayers that need a compliance review.

IMPLEMENTATION DATE:

January 15, 2020

RESPONSIBLE OFFICIAL:

Director, Specialty Examination, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 4:

The Commissioner, Small Business/Self-Employed Division should develop a risk-based case selection methodology using historical statistics and data analysis to identify the highest risk tip examination cases on an annual basis. For example, the IRS could focus on taxpayers with projected unreported tips in a high dollar value. The cases could then be classified based on the updated prioritization of Field resources available for tip examinations.

CORRECTIVE ACTION:

We agree with the recommendation. We will review the current process to determine whether improvements are needed for identifying higher risk tip examinations, taking into consideration historical statistics and annual data analysis.

IMPLEMENTATION DATE:

October 15, 2019

RESPONSIBLE OFFICIAL:

Director, Specialty Examination, Small Business/Self-Employed Division



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

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CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 5:

The Commissioner, Small Business/Self-Employed Division, should use the NTRCP CETO function to complete the Notice and Demand letter process for closed tip examinations when Field Examination resources are limited. The CETO function already performs this work for the Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*, tip compliance workstream so it would not be a new process for them.

CORRECTIVE ACTION:

We agree with the recommendation. We will review the current process for working 3121(q) Notice and Demands for closed tip examinations to determine whether CETO resources can be used to supplement Field resources.

IMPLEMENTATION DATE:

October 15, 2019

RESPONSIBLE OFFICIAL:

Director, Specialty Examination, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 6:

The Commissioner, Small Business/Self-Employed Division should update the Tip Examination Internal Revenue Manual (IRM) to clarify the requirements for making a determination and documenting the reasons to expand or limit the scope to prior and/or subsequent years. The documentation should include the use of further analysis to justify the reason for expanding or limiting the scope of the audit to prior/subsequent years.

CORRECTIVE ACTION:

We agree with the recommendation. We will issue an Interim Guidance Memorandum to clarify the requirements for making a determination and documenting the reasons to expand or limit the scope to prior and/or subsequent years. It will include the use of further analysis to justify the reason for expanding or limiting the scope of the audit to prior/subsequent years.



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IMPLEMENTATION DATE:

October 15, 2019

RESPONSIBLE OFFICIAL:

Director, Specialty Examination, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 7:

The Commissioner, Small Business/Self-Employed Division should consider reducing the number of approvals necessary to revoke tip agreements with noncompliant employers.

CORRECTIVE ACTION:

We agree with the recommendation. We will review the delegation order for revoking tip agreements to determine whether any revisions are needed.

IMPLEMENTATION DATE:

October 15, 2019

RESPONSIBLE OFFICIAL:

Director, Specialty Examination, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 8:

The Director, SB/SE Division, Specialty Examination should update the IRM to provide more specific criteria and examples of when to revoke a tip agreement if an establishment is substantially noncompliant with the commitments of the agreement; provide more specific criteria and examples on how to perform compliance reviews, including the Form 8027, *Employer's Annual Information Return of Tip Income and Allocated*, analysis of unreported tips; and provide employee training on the changes to the IRM.

CORRECTIVE ACTION:

We agree with the recommendation. We will issue an Interim Guidance Memorandum to provide more specific criteria and examples of when to revoke a tip agreement, if an establishment is substantially non-compliant with the commitments of the agreement; and provide more specific criteria and examples on how to perform compliance reviews,



Billions in Tip-Related Tax Noncompliance Are Not Fully Addressed and Tip Agreements Are Generally Not Enforced

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including the Form 8027 analysis of unreported tips. Training workshop will be delivered to ensure employees understand and implement the IGM.

IMPLEMENTATION DATE:

October 15, 2019

RESPONSIBLE OFFICIAL:

Director, Specialty Examination, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 9:

The Commissioners, SB/SE and TE/GE Divisions, should ensure 4137 Compliance cases are addressed in the CETO function's annual work plans, including the TY 2013 through 2015 cases, which involved more than \$1.5 million in potential increased FICA tax revenue.

CORRECTIVE ACTION:

We agree with the recommendation. SB/SE filters used to identify higher risk FY2016 TE/GE Indian Tribal Government (ITG) Form 4137 compliance cases will be applied to the FY2013 – 2015 TE/GE ITG Form 4137 compliance cases. TE/GE ITG's higher risk cases will be included in the SB/SE CETO workplan as resources permit.

IMPLEMENTATION DATE:

October 15, 2019

RESPONSIBLE OFFICIAL:

Director, Specialty Examination, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.