

Special Section: FOOD & BEVERAGE



A Call for NYC Guidance on Federal Tip Credit

By Kurt S. Kiess / Marks Paneth LLP

Restaurant owners located in New York City are left in the difficult position of interpreting the rules on the federal tip credit. The New York City Department of Finance has not issued clear and definitive guidelines on how to treat the federal tip credit as it relates to New York City taxable income. As a result, New York City restaurant owners may be paying tax on phantom income – not real income but rather paper income for which there is no cash to offset the tax burden. The lack of clarity has created inconsistent reporting throughout the city, placing a burden on the New York City restaurant industry – an industry that is vital to the city's economy.

The federal tip credit is a unique, and huge, benefit for restaurant owners, who otherwise face pitfalls including wage/hour and tip-related issues and sales tax complications.

How does the credit work? According to federal tax laws, tips paid by customers to employees are taxable income. This includes Social Security tax, which is normally paid by employer and employee in equal amounts.

But tips are different, since they're paid by customers directly to employees. Employers are required to report their employees' tips on their W-2s. Employees do not contribute any dollars to the restaurant for payment of their share of Social Security taxes. Instead, restaurants pay both the employee and the employer taxes on the amounts of tips reported. This is an extra tax for owners: the restaurant must pay Social Security taxes on income (tips) that it didn't provide.

The federal tip credit is a move by Congress to provide

relief from this extra tax. It allows a tax credit to restaurant owners for the Social Security tax they paid on behalf of their employees. There is a restriction, however: in order to claim this credit, the extra amount paid in taxes cannot be deducted as an expense.

Let's assume that a restaurant breaks even – there is no profit or loss (no cash generated). In calculating the taxable income, the restaurant deducted \$25,000 of Social Security taxes paid on

behalf of tips reported by its employees. If the restaurant owner elected the federal tip credit, it would now not take the deduction and would instead report \$25,000 in income purely for federal income tax purposes. However, it would also claim \$25,000 in federal tip credits against taxable income, which is far more advantageous than the deduction.

The New York City Department of Finance auditors have taken varying positions in situations such as the example above. Some auditors have allowed the federal tip credit as a reduction of taxable

net income while others do not. However, while the department is silent on the federal tip credit, it does give clear guidance on issues such as charitable contributions and deductions as well as on other federal wage credits: Indian Employment Credit, employer wage credit for employees who are on active duty in the military, Empowerment Zone employment credit, housing tax benefits and employment relief. All these federal wage credits are similar to the federal tip credit and all are clearly defined as deductions to federal taxable income in order to reach New York City taxable income.¹

This issue is not unique to New York City. Certain states, such as Pennsylvania and Oregon, have provided clear guidance that allows the federal tip credit as a deduction to reach taxable



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income. Some states, such as Colorado, say it is not an allowable adjustment. Other states do not begin with federal taxable income but rather show a proper profit-and-loss statement; therefore, the federal tip credit is not part of the calculation.

In our example, without New York City's guidance, it could be interpreted that the \$25,000 the restaurant paid in Social Security taxes does not count as a deduction and results in \$25,000 of city income (i.e. phantom income since the restaurant is cash break-even) that could yield a tax ranging from \$1,000 to \$2,250.

New York City's position isn't logical, and it could create an unfair cost to this vital industry, in which owners already

face many pitfalls. Says Joanne Taylor, chief financial officer, B&B Hospitality Group, "The idea that we have to pay tax on income we never see is absurd. It makes success in this low-margin industry even more difficult."

In order to be fair, taxes should be based on real economic results. The New York City Department of Finance needs to issue clear guidance on the treatment of the Social Security taxes related to the federal tip credit to relieve a challenged industry of the potential burden of paying a tax that is based on phantom income.

1. These wage credits are found in IRC sections 45A(a), 45P(a), 51(a), 1396(a), 1400p(b) and 1400R. The federal tax credit, however, is found under 45(B) and is not covered by section 28C.