

Form 4137

Compliance Program

**Frequently
Asked
Questions**



The IRS' Form 4137 Compliance Program uses data from employees' Forms 4137, Social Security and Medicare Tax on Unreported Tip Income, to determine the social security and Medicare taxes owed by the employers of tipped employees.

Employers in industries where tipping is customary know that they must pay the employer's share of social security and Medicare taxes on tips employees report to them. However, many employers do not realize that they may be liable for these same taxes on tips employees do not report to them.

For tips which the employees did not report to the employer, the employer's liability for the employer's share does not arise until IRS issues a Section 3121(q) Notice and Demand. In the past, the IRS has issued notice and demands based on the results of employer or employee tip audits.

Under the Form 4137 Compliance Program, a Section 3121(q) Notice and Demand will be based on information the IRS collects from employees' Forms 4137. Employees use Form 4137 to report and pay their share of social security and Medicare taxes due on the tips they did not report to their employer. This includes any tips allocated to employees of large food and beverage establishments. Generally, employees must include the allocated tips as income on their income tax returns unless they have adequate records to show that they received less tips in the year than the allocated figures.

The IRS generally intends to notify an employer at least 30 calendar days in advance of the issuance of a Section 3121(q) Notice and Demand by issuing a pre-notice. The IRS has a designated staff to help resolve any discrepancies the employer notes on the pre-notice.

A Section 3121(q) Notice and Demand instructs the employer to include the social security and Medicare taxes shown on the notice and demand on the employer's next *Form 941, Employer's QUARTERLY Federal Tax Return*. The employer will not be subject to any interest charges or deposit penalties if the employer properly reports and pays the taxes as instructed in the notice and demand.

FORM 4137 – IRC 3121(q)

FREQUENTLY ASKED QUESTIONS

Q1. What tips does an employee have to report to his or her employer?

- A1.** All cash tips received by an employee constitute wages for social security tax, Medicare tax, and income tax withholding purposes and, therefore, must be reported to the employer unless the cash tips received by the employee during a single calendar month while working for any one employer total less than \$20. Cash tips include tips received from customers, charged tips distributed to the employee by his or her employer, and tips received from other employees under any tip-sharing arrangement.

Q2. How are tips reported by the employee to the employer?

- A2.** For each calendar month during which an employee receives \$20 or more in cash tips, the employee must give the employer a written statement (or statements) of cash tips by the 10th day of the month after the month in which the tips are received. Form 4070, Employee's Report of Tips to Employer, is available for this purpose, and can be found in Publication 1244, Employee's Daily Record of Tips and Report to Employer. The statement may be furnished on paper or transmitted electronically. See Treas. Reg. 31.6053-1(b). Tips reported to the employer by the employee are included in Box 1 (Wages, tips, other compensation), Box 5 (Medicare wages and tips), and Box 7 (Social security tips) of the employee's Form W-2, Wage and Tax Statement.

Q3. If an employee fails to report tips to his or her employer, how are social security and Medicare taxes paid on those tips by an employee?

- A3.** Employees who did not report tips to their employers, including any allocated tips shown in box 8 of their Form(s) W-2, use Form 4137, Social Security and Medicare Tax on Unreported Tip Income, to figure the social security and Medicare tax owed on those tips. These unreported tips are then included as additional wages and reported on their Form 1040, U.S. Individual Income Tax Return.

Generally, if the employee's Form W-2 shows allocated tips, the employee must report the allocated tip amount on Form 4137. However, if the employee has a daily tip record or other credible evidence to show that the actual tips the employee received are less than the combined amount of the tips the employee reported to his/her employer and the allocated tips, only the difference between the reported tips and the actual tips must be reported on Form 4137 as unreported tip income.

Q4. What are allocated tips?

A4. An employer who operates a large food or beverage establishment must allocate tips among its tipped employees if the total tips reported to the employer during any payroll period are less than 8% (or the approved lower rate) of the establishment's gross receipts for that period. Allocated tips are computed and reported on Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips. See IRC section 6053(c)(3), Treas. Reg. 31.6053-3, and the Instructions for Form 8027.

Generally, the amount to be allocated is the difference between the total tips reported by the tipped employees and 8% (or the approved lower rate) of the gross receipts, other than non-allocable receipts. Employers report allocated tips in Box 8 (Allocated tips) of the tipped employee's Form W-2. Tips reported to the IRS on Forms 4137, but not reported to the employer may include all or a portion of the tips allocated and tips in excess of the allocation the employer included in Box 8 of its employee's Form W-2. When an employee reports tips in excess of the amount allocated, the employee is informing the IRS that he or she earned tips in excess of the 8% allocation made by their employer, but did not report those tips to the employer when received.

Q5. If an employee fails to report tips to his or her employer, when is an employer liable for social security and Medicare taxes on those tips?

A5. If an employee fails to report tips to his or her employer, the employer is liable for the employer share of social security and Medicare taxes on the unreported tips when a Section 3121(q) Notice and Demand for the taxes is made to the employer by the IRS. Notice and demand is made by the IRS when it advises the employer in writing of the amount of tips received by an employee (or employees) who failed to report or under-reported tips to the employer. The notice to the employer specifically identifies that it is a "notice and demand" under "section 3121(q)."

In the Form 4137 compliance program, the IRS will send an employer a Section 3121(q) Notice and Demand (Letter 4520) detailing the data collected from their employees' Forms 4137, showing the computation of the employer's tax liability and the required payment for the employer's share of the employment taxes. In the past, the IRS did not assess the employer's share of social security and Medicare taxes on unreported tips shown by employees on Forms 4137 because the form previously did not capture the employer identification number and tip information applicable to each employer. The IRS revised Form 4137 to capture this information and instituted a compliance program to collect the employer's share of taxes on additional tip income reported on the tipped employee's income tax return.

Q6. What is Letter 4520-P?

A6: In advance of the issuance of a Section 3121(q) Notice and Demand (Letter 4520), generally, the IRS will send a “pre-notice” (Letter 4520-P). This pre-notice will give the employer the opportunity to dispute the information provided. The pre-notice has contact information for the Employment Tax Operations designated staff to resolve discrepancies raised by the employer. The pre-notice is not a Section 3121(q) Notice and Demand.

Q7. Can an employer get an extension of time to respond to the pre-notice (Letter 4520 P)?

A7: Yes. Contact the IRS in the manner instructed in the pre-notice (Letter 4520-P). An IRS employee will discuss the employer’s needs and the requested extension of time with his or her group manager. The employer will be notified of their decision. If the employer is granted an extension, the employer will be given a new deadline for submitting information.

Q8. What should an employer do if it does not agree with the amounts shown in the pre-notice (Letter 4520 P) for some of the employees listed?

A8: Contact the IRS in the manner instructed in the pre-notice (Letter 4520-P). You may submit a list of the employees in question and explain your basis for contending that the tips are incorrect. We will research your inquiry and make any adjustments necessary based on obvious errors or inconsistencies discovered. The pre-notice (Letter 4520-P) is based on Forms 4137 filed by your employees reporting additional tip income on their individual income tax returns, Forms 1040.

Q9. If an individual listed in the attachment to the pre-notice (Letter 4520-P) did not work in a tipped capacity, what should the employer do to resolve this inquiry?

A9: Contact the IRS in the manner instructed in the pre-notice (Letter 4520-P). Inform the IRS if your business does not lend itself to tipping. The worker may have used the incorrect form. The IRS may contact the employer to ask specific questions about the business, the type of document(s) the employer issued to the worker at year-end (Form W-2, Form 1099-MISC (Miscellaneous Income), etc.), and the job(s) held by the worker.

Q10. How does an employer, who files Form 941, Employer's QUARTERLY Federal Tax Return, report the social security and Medicare tax liability after notice and demand is made?

A10: As part of the Form 4137 compliance program, the IRS will send an employer a Section 3121(q) Notice and Demand (Letter 4520). For purposes of applying the deposit rules, the amount of employer social security and Medicare taxes attributable to the amount of tips received by the employee (or employees), as shown on the Section 3121(q) Notice and Demand, is treated as employment taxes accumulated by the employer on the date the Section 3121(q) Notice and Demand is made, which is the date printed on the notice and demand document.

The employer reports the amount of the section 3121(q) social security and Medicare tax liability as a current period liability on the employer's Form 941 for the calendar quarter in which notice and demand is made. Employers should consult the Section 3121(q) Notice and Demand (Letter 4520) to determine the correct line entry on Form 941.

The employer must also include the amount of the section 3121(q) tax liability on the appropriate report of federal tax liability. For semi-weekly schedule depositors, include the tax liability on the numbered space on Schedule B (Form 941), Report of Tax Liability for Semiweekly Schedule Depositors that corresponds to the date of the Section 3121(q) Notice and Demand. For monthly schedule depositors, include the tax liability on the line for the month in Part 2 of Form 941 that corresponds to the date of the notice and demand. For example, if the Date of Notice and Demand is March 29, 2013, include this tax liability on the line for Month 3 in Part 2 of the Form 941 for the 1st quarter 2013. Reminder: The amounts reported in Part 2 are a summary of your monthly tax liability not a summary of the deposits you made.

Q11. How does the employer pay the tax?

A11: The IRS will issue a Section 3121(q) Notice and Demand (Letter 4520) to the employer which will provide specific guidance. An employer should review its deposit requirements and be prepared to make a deposit, if required, for the tax due as of the date of the Section 3121(q) Notice and Demand.

Depending on the amount due, an employer may be able to remit the payment with the Form 941. See the Instructions for Form 941. If the amount due for the section 3121(q) tax liability and other taxes for the quarter exceed the dollar limitation for remittance with a filed return, an

employer should make a deposit according to the deposit rules, to avoid any possible deposit penalty. If the employer uses a payroll service, the employer should notify them immediately upon receipt of the Section 3121(q) Notice and Demand.

Q12. An employer understands that the additional tips reported by many of its employees represent allocated tips shown on their Forms W-2. Is there any way that the employer can report those tips in Box 1 (Wages, tips, other compensation), Box 5 (Medicare wages and tips), and Box 7 (Social security tips) of the Forms W-2, Wage and Tax Statement and pay the taxes on Form 941 for the year in which they are allocated so that it won't have this unplanned liability in the future?

A12: No. An employer can only include tips reported to the employer by its employee in Box 1, Box 5, and Box 7 of the employee's Form W-2. All allocated tips are to be reported in Box 8 (Allocated tips) of the tipped employee's Form W-2. An employer is not liable for the employer share of the social security and Medicare taxes on allocated tips when it makes the allocation.

If an employer repeatedly has to allocate tips to its employees, it may indicate a weakness in the employer's internal controls for employee tip reporting, or a lack of understanding or adherence to the tip reporting laws by its tipped employees. A thorough review of the internal controls for the employer's tip reporting system along with employee tip reporting education seminars may be appropriate. IRS Publication 531, Reporting Tip Income, provides a comprehensive review of the tip income tax laws. IRS Publication 531 is available electronically or in hard copy and can also be used as an employee training tool. Employers or employees can obtain the publication by visiting Forms and Publications at the IRS website, www.irs.gov, or by calling 1-800-TAX-FORM (1-800-829-3676). When employees report their tips accurately to their employer, the allocation of tips is usually not necessary.

The best way to minimize any unexpected IRC section 3121(q) assessments is for an employer to educate its employees on their tip reporting responsibilities and to administer a tip reporting system that allows its employees to report their tips accurately when received. This should help reduce or eliminate any unanticipated tax liability based on Forms 4137 filed by employees.

Q13. If an employer receives the pre-notice (Letter 4520-P) and agrees that it owes the stated taxes, can the employer include the amount immediately on the current quarter's Form 941 instead of waiting until the Section 3121(q) Notice and Demand is issued?

A13: No. The employer must wait until the Section 3121(q) Notice and Demand (Letter 4520) is issued to include the amount on its Form 941. An employer is liable for the employer share of social security and Medicare taxes on the unreported tips when notice and demand for the taxes is made to the employer by the IRS. A pre-notice is not a Section 3121(q) Notice and Demand.

For example, the IRS issues a pre-notice (Letter 4520-P) to Employer X on September 20, 2012. Employer X contacts the IRS on September 28, 2012, and indicates that it would like to make the payment on September 28, 2012 and show the section 3121(q) tax liability on the Form 941 for the 3rd quarter 2012 rather than wait until the Section 3121(q) Notice and Demand (Letter 4520) is issued. The IRS employee tells Employer X that the Section 3121(q) Notice and Demand will not be issued until October, 2012, which is in the 4th quarter 2012. Employer X can make the deposit immediately by EFTPS (Electronic Federal Tax Payment System) as long as it designates the deposit for the Form 941 for the 4th quarter 2012. Employer X will include the amount of the section 3121(q) tax liability on the Form 941 for the 4th quarter 2012, after the Section 3121(q) Notice and Demand is issued.

Q14. If an employer receives a Section 3121(q) Notice and Demand (Letter 4520) after it closed its business, is the employer still liable? How does the employer report and pay the amount it owes?

A14. Yes, the employer is still liable. Under IRC section 3121(q), an employer's tax liability on unreported tips arises when the IRS issues the employer a Section 3121(q) Notice and Demand to collect the employer share of social security and Medicare taxes on those tip amounts. Thus, even though the employer is no longer in business, the employer is still liable for the tax on tips its employees earned, but did not report to the employer during their employment.

If an employer ceased business operations, it should have filed a final return for the last quarter wages were paid. Even though a final return was filed, if an employer pays any wages or other taxable compensation for periods following the cessation of the business, the employer must file a Form 941, Employer's QUARTERLY Federal Tax Return, for that period. See Publication 15, (Circular E), Employer's Tax Guide, for additional information. Although an employer filed a final return and may not have filed a Form 941 for some time, the employer must file a Form 941 for the quarter in which the Section 3121(q) Notice and Demand is made, which is the date printed on the notice and demand document. An employer should mark the checkbox on Form 941 to indicate that its business has closed or it stopped paying wages and enter the date of the Section 3121(q) Notice and Demand as the final date it paid wages. The IRS will then not expect the employer to file subsequent Forms 941.

Q15. Is the Section 45B credit, with respect to the tips reported on the Section 3121(q) Notice and Demand, available to the employer in the year the Section 3121(q) Notice and Demand is made or does an employer need to file an amended return for the year in which the unreported tips were received by the employee?

A15: The Section 45B credit is available to the employer in the year the Section 3121(q) Notice and Demand is paid and not the year in which the unreported tips were received by the employee. The Section 45B credit is applied to the taxable year that the "excess social security tax" amount is paid or incurred. The term "excess employer social security tax" means any tax paid by an employer under IRC section 3111 (both social security tax and Medicare tax) on its employees' tip income without regard to whether the employees reported the tips to the employer. The credit is claimed on Form 8846, Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips.

More information about tip reporting, allocated tips, and social security and Medicare taxes are in:

- Publication 15 (Circular E), Employer's Tax Guide
- Publication 531 Reporting Tip Income
- Instructions for Form 941
- Topic 761 - Tips - Withholding and Reporting
- Instructions for Form 8027

<http://www.irs.gov/businesses/small/selfemployed/article/0,,id=223803,00.html>

