2026 NATIONAL INCOME TAX WORKBOOK

Chapter 5: Restaurant & Hospitality Businesses

Land Grant University
Tax Education Foundation

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LEARNING OBJECTIVES

- ✓ Understand the employee tip reporting requirements
- ✓ Distinguish between tip income and wage income
- ✓ Understand the employer tip reporting requirements
- ✓ Calculate the employer tip credit
- ✓ Learn how to calculate the deduction for qualified tips
- ✓ Learn how to calculate the deduction for qualified overtime

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LEARNING OBJECTIVES

- ✓ Define qualified improvement property
- ✓ Calculate the net savings from a cost segregation study
- ✓ Explain the safe harbor method for remodel and refresh projects
- ✓ Understand the smallwares safe harbor method

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TIP INCOME AND REPORTING

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Tip Income and Reporting: Overview

- **Tipped employees must keep daily records of tips and report them to their employer**
- Tips are included in gross income as wages
- Tips are subject to income, Social Security, and Medicare tax withholding

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Tip Income and Reporting: Overview

- Large food and beverage employers must file an annual information return (tip income and allocated tips)
- IRS offers voluntary tip-reporting compliance programs

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Employee Tip Reporting

An employee who receives tips generally must:

- Keep daily records of tips received
- Report the tips to the employer
- Report the tips on his or her federal income tax return

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Daily Tip Record

Employees must keep a daily tip record (tip diary or copies of bills/charge slips)

Diary should show employer's name and business name

For each workday, record:

- Date, Cash tips, CC tips, Noncash tips
- Tips paid out to other employees

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Daily Tip Record

P. 169

- If the employer keeps an electronic tip record, the employee must receive a paper copy
- Noncash tips are **NOT** reported to the employer, but **ARE** reported on the employee's tax return
- Service charges added to customer bills and paid to employees as wages are **NOT** tip income

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Practitioner Note: Historical Forms 4070 and 4070A

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- IRS Publication 1244 (Employee's Daily Record of Tips and Report to Employer) became obsolete beginning in 2024
- The most recent revised Form 4070 (Employee's Report of Tips to Employer) and Form 4070A (Employee's Daily Record of Tips)
  - **www.irs.gov/pub/irs-prior/p1244--2005.pdf**

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Example 5.1: Service Charges

P. 169

- Riverside Restaurant adds an 18% charge for parties of 6+
- Customer's $300 bill → $54 service charge added
- Customer enters $20 on the additional tip line ($74 total tip line)
- Result: tip = $20; wages = $54
- Server does not include the $54 service charge in his tip diary

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Reporting Tips to the Employer

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Employees receiving $20 or more in tips (cash, check, debit, or credit card) in a calendar month must report tips to the employer

Why reporting matters:

- Employer must withhold income, Social Security, and Medicare taxes
- Reported earnings affect Social Security retirement, disability, and beneficiary benefits
- Failure to report → penalty of 50% of FICA taxes owed

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Reporting Tips to the Employer

P. 170

- Noncash tips are not reported to the employer (not subject to FICA), but are subject to income tax and must be included in gross income
- **Deadline**: report by the 10th day of the month following the month tips were received
- Employers can require more frequent reporting
- If employment ends during the month, the employee may report tips at that time

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Reporting Tips to the Employer

P. 170

The **signed and dated tip report** must include:

- Employee's name, address, and SSN
- Employer's name, address, and business name (if different)
- The month (or shorter period) in which tips were received
- Total tips received during the period

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Practitioner Note: Tips Deemed Paid to Employee When Reported to Employer

P. 170

- Tips reported to an employer are deemed paid when the written statement is furnished
- Example: December 2026 tips reported on January 10, 2027 → deemed received in 2027
- Tips not required to be reported to the employer are deemed paid when actually received

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Example 5.2: Employee Tip Reporting

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- Ramon is a server at Parish Mill Restaurant
- **Sept. 2026**: $1,540 cash tips **+** $1,040 credit/debit card tips; paid out $410 to kitchen staff
- October 10 is a Saturday; October 12 is a legal holiday
- **Result**: Ramon must report Sept. tips by October 13, 2026
- **Form 4070 net tips**: $2,170 ($1,540 + $1,040 - $410) (Figure 5.1)

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Required Withholding

P. 171

If regular pay can't cover taxes on reported tips, the employee may give the employer money to cover them

If funds still fall short, the employer applies funds in this order:

- All taxes on the employee's regular pay
- Social Security and Medicare taxes on reported tips
- Federal, state, and local income taxes on reported tips

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Required Withholding

P. 171

Remaining unpaid taxes withheld from the next paycheck or collected from the employee before year-end

Employer reports any remaining uncollected taxes at year-end on **Form W-2, box 12**:

- Code A: uncollected Social Security tax on tips
- Code B: uncollected Medicare tax on tips

These amounts are due with the employee's return

- → may trigger the estimated tax underpayment penalty

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Reporting Tips on the Tax Return

P. 171

- Tips reported to the employer are included in Form W-2, box 1 → Entered on Form 1040, line 1a
- Tip income **NOT** on line 1a is reported on line 1c, including:
  - Tips under $20/month not previously reported to the employer
  - Value of noncash tips (tickets, passes, etc.)
  - Allocated tips from W-2, box 8 (unless unreported tips are less than the box 8 amount)

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Form 4137: Reporting Tips on the Tax Return

P. 172

For employees who received $20+ in monthly tips and did not report those tips to the employer → employee must:

- Include the unreported tips in income; and
- Pay FICA taxes on them via Form 4137 (Social Security and Medicare Tax on Unreported Tip Income)

Tax calculated on Form 4137 → entered on Schedule 2 (Form 1040), line 5 (or Form 1040-SS, line 6a)

Penalty: 50% of FICA tax due on unreported tips

- Avoidable with a reasonable cause statement attached to return

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Example 5.3: Unreported Employee Tips

P. 172

- Greta's W-2 box 1: $34,200 (includes $27,000 reported tips)
- Her records show $28,100 actual tips → $1,100 unreported
- Greta reports $35,300 on Form 1040, line 1a
- Uses Form 4137 to calculate FICA on unreported tips → $84 → enter on Schedule 2, line 5 (Figure 5.2)
- Without reasonable cause, may owe penalty of 50% on $84

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Allocated Tips

P. 173

- Large food and beverage businesses (more than 10 employees on a typical business day) must calculate tip allocation if reported tips <8% of food and drink sales
- The shortfall is allocated to tipped employees who reported below 8%
- No allocation to employees participating in the TRAC program
- Allocated tips are reported on box 8 of Form W-2

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Allocated Tips

PP. 173-174

Employees generally add allocated tips to wages (line 1a) **and** must also complete Form 4137 reporting allocated tips

Exceptions – **do not** include allocated tips if:

- The employee kept a daily tip record; or
- The record is incomplete but shows actual tips exceeded reported + allocated tips

If an exception applies → report actual tips received instead.

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Allocated Tips: Lower Rate Petition

P. 174

- An establishment can request IRS approval for a tip rate below 8% (but not below 2%)
- The business **OR** the employee may petition
- An employee petition requires consent of a majority of directly tipped employees
- See **Form 8027** instructions for petition procedures

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Examples 5.4 & 5.5: Allocated Tips

P. 174

- **Example 5.4**: Tanya kept a complete daily tip record; W-2 box 8 shows $325 allocated tips → she does not report the allocated tips
- **Example 5.5**: Same facts, but her record is incomplete and does not show actual tips exceeded reported + allocated → she must add the $325 to line 1a wages and complete Form 4137

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Employer Tip Reporting

P. 174

- Reported tips are included in wages for federal tax purposes
- Employers must withhold income & FICA on reported tips
- Employers are liable for the employer portion of FICA on those reported tips

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Tip Credit

P. 174

- **FLSA**: tipped employee's minimum cash wage can be reduced to $2.13/hour if tips + cash wage meets or exceeds federal minimum wage
- If total tip + wage rate exceeds federal minimum wage → qualifying employers may claim a nonrefundable credit [I.R.C. § 45B]
- Credit = employer's share of FICA taxes paid **on tips not treated as wages** to meet the FLSA minimum wage requirement

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Tip Credit: Special Rules

PP. 174-175

- **Qualifying Employer** = employees are tipped for providing, delivering, or serving food or beverages
- **Jan. 1 2025**: includes barbering and hair care, nail care, esthetics, and body and spa treatments
- Credit is available if the employer paid FICA taxes on tips
- Employer cannot deduct amounts used to compute credit qualification
- **Election:** Employer may elect out on original return or an amended return filed within 3 years of the due date

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Tip Credit: Federal Minimum Wage Rule

For computing tip credit only: Employers use the **$5.15/hour** federal minimum wage in effect on January 1, 2007

Result: increases in the minimum wage do not reduce the FICA tip credit

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P. 175

Tip Credit: Claiming the Credit

General Business Credit – claimed on **Form 8846**

- Form 8846, line 6 amount → Schedule K (Form 1065 or 1120-S) or Form 3800, Part III, line 4f for other taxpayers

Income tax credit: offsets regular income tax **and** AMT

Cannot offset employment tax liabilities

Unused credit: carry back 1 year, forward 20 years

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Practitioner Note: Work Opportunity Credit

P. 175

- The I.R.C. § 51 work opportunity credit for qualified first-year wages paid to a targeted-group employee expired on December 31, 2025

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Example 5.6: Employer Tip Credit

PP. 175-176

City Café pays employees $2.13/hour

2026: 10 employees, 20,000 hours, $380,000 reported tips

Employer's FICA match: $29,070 ($380,000 x 7.65%)

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Example 5.6: Employer Tip Credit

PP. 175-176

Tips needed to bring wages to $5.15/hour are **NOT creditable**:

- **Ineligible**: ($5.15-$2.13) x 20,000 hours = $60,400
- **Creditable tips**: $380,000 - $60,400 = $319,600

Tip credit: $319,600 x 7.65% = $24,449 (Form 8846, Figure 5.3)

FICA deduction reduced by tip credit: $29,070 - $24,449 = $4,621

Wage deduction limited to $42,600 (20,000 hours x $2.13)

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Form 8027: Filing Requirement

P. 176

- Large food or beverage establishments meet all of the following:
  - Provides food or beverages for consumption on the premises
  - Tipping is a customary practice
  - More than 10 employees, working more than 80 hours, were normally employed on a typical business day in the preceding calendar year

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Form 8027: Filing Requirement

PP. 176-177

- Food and beverage employees include: waiters, busboys, bartenders, hosts, wine stewards, cooks, and kitchen help
  - **NOT** coat check persons, bellhops, doormen
- 50% or more shareholder → **NOT** an employee
- New establishments meeting the 80-hour test for 2 consecutive months must file for the rest of the year

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Form 8027: Filing Exceptions

P. 177

Form 8027 is **not** required for:

- Establishments operated less than 1 month during the year
- Fast food restaurants and other operations where tipping is not customary, or where 95% of total sales (other than carryout) had a 10% or more service charge

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Example 5.7: The 10-Employee Test

P. 177

- Seafood Shack – 2025 data:
  - Highest gross receipts months (July): open 25 days, 2,400 employee hours
  - Lowest gross receipts month (Dec.): open 20 days, 2,000 employee hours
- Seafood Shack uses the **worksheet** included in the instructions for **Form 8027 (Figure 5.4)** to determine if they must file Form 8027
- Because line 7 is greater than 80, Seafood Shack must file

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Form 8027: Gross Receipts

P. 177

Gross Receipts for Form 8027 include:

- Cash sales, charge receipts, hotel room service charges (excluding separately stated tips), and sometimes the retail value of complimentary food or beverages

Charged tips count as charge receipts **only if** cash sales were reduced by cash paid out for those charged tips

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Form 8027: Gross Receipts

P. 177

Gross receipts **do not** include:

- State and local taxes
- **Nonallocable receipts**

Nonallocable receipts: carryout sales and receipts with service charge of 10% or more

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Practitioner Note: Complimentary Food and Beverages

P. 178

- Complimentary items count in gross receipts **only if** tipping on them is customary **and** they are provided in connection with a for-profit activity whose gross receipts are not food/beverage receipts (e.g., casino)
- Complimentary bar snacks or desserts for restaurant regulars → not included
- Fruit basket in a hotel room → not included (tipping not customary)

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Tip Allocation Methods

P. 178

- Hours-worked method
- Gross-receipts method
- Good-faith agreement

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Tip Allocation: Hours-Worked Method

P. 178

- **Available only if** average hours worked per business day in a pay period is **less than** 200 hours (≈ 25 full-time employees)
- All food and beverage employees' hours count toward the 200 hours
- Only **tipped** employees' hours are used to prorate shortfall
- Same process as gross-receipts methods, substituting hours for sales – no need to track each employee's sales
- Check box on Form 8027, line 7a

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Tip Allocation: Gross-Receipts Method

PP. 178-179

Required if the employer doesn't qualify for hours-worked method and has no good-faith agreement; required tracking each employee's sales

Steps 1-3:

- Gross receipts x 8% (or lower approved rate)
- Subtract indirectly tipped employees' reported tips → this amount is the directly tipped employees' share
- Multiply each directly tipped employee's gross-receipts ratio by the step 2 amount → each employee's share

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Tip Allocation: Gross-Receipts Method

PP. 178-179

Steps 4-6:

- Employee's share (step 3) – Employee's actual reported tips = **individual shortfall**; total all shortfalls (ignoring overages)
- Step 1 amount – total reported tips (direct & indirect) = **allocable shortfall**
- (Individual shortfall ÷ total shortfall) x allocable shortfall = each employee's allocated tips

Employers using Gross-receipts method must check box on Form 8027, line 7b

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PP. 179-180

Example 5.8: Gross-Receipts Method

- **Taqueria Restaurant**:
  - **Gross receipts**: $100,000
  - **Total reported tips**: $6,200 ($500 by indirectly tipped employees)
- **Step 1**: $100,000 (gross receipts) x 8% = $8,000
- **Step 2**: $8,000 (step 1) - $500 indirectly tipped employees reported tips = $7,500

Figure 5.5

Directly Tipped Employee	Gross Receipts for Pay Period	Reported Tips
Anderson	$18,000	$1,080
Baldwin	16,000	880
Caldwell	23,000	1,810
Duncan	17,000	800
Edmondson	12,000	450
Frazier	14,000	680
Total	**$100,000**	**$5,700**

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PP. 179-180

Example 5.8: Gross-Receipts Method

- **Step 3**: Multiply the gross receipts ratio for each directly tipped employee by the amount from step 2 ($7,500)

Directly Tipped Employee (DTE)	Gross Receipts Ratio	DTE Share of 8% Gross Receipts (Step 2)	Employee's Share of 8% of Gross Receipts
Anderson	$18,000 ÷ $100,000	$7,500	$1,350
Baldwin	$16,000 ÷ $100,000	$7,500	1,200
Caldwell	$23,000 ÷ $100,000	$7,500	1,725
Duncan	$17,000 ÷ $100,000	$7,500	1,275
Edmondson	$12,000 ÷ $100,000	$7,500	900
Frazier	$14,000 ÷ $100,000	$7,500	1,050
Total			**$7,500**

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Example 5.8: Gross-Receipts Method

PP. 179-180

- **Step 4**: Subtract the reported tips from the amounts calculated in step 3 (Employee's Share of 8% Gross Receipts)

Directly Tipped Employee (DTE)	Employee's Share of 8% Gross Receipts	Reported Tips	Employee Shortfall
Anderson	$1,350	$1,080	$270
Baldwin	1,200	880	320
Caldwell	1,725	1,810	-
Duncan	1,275	800	475
Edmondson	900	450	450
Frazier	1,050	680	370
Total	**$7,500**	**$5,700**	**$1,885**

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Example 5.8: Gross-Receipts Method

PP. 179-180

- **Step 5**: $8,000 (step 1) - $6,200 total reported tips = $1,800 allocable amount
- **Step 6**: Multiply the shortfall ratio by the allocable amount (step 5)

Shortfall Employees	Shortfall Ratio	Allocable Amount	Allocation Amount
Anderson	$270 ÷ $1,885	$1,800	$258
Baldwin	$320 ÷ $1,885	$1,800	$306
Duncan	$475 ÷ $1,885	$1,800	$454
Edmondson	$450 ÷ $1,885	$1,800	$430
Frazier	$370 ÷ $1,885	$1,800	$353

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Tip Allocation: Good-Faith Agreement

P. 181

Written agreement between employer and at least 2/3 of employees in **each** tipped occupational category (server, bussers, hosts, etc.)

Agreement must:

- Allocate the shortfall in a way that approximates actual tip income distribution
- Be effective the first day of a payroll period after adoption (no later than January 1 of the following year)
- Be adopted when there are employees in each affected category
- Allow for revocation by a later 2/3 written agreement

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Form 8027: When to File

P. 181

- Due the last day of February; electronic filers have until March 31
- Form 8809: extension of time to file Form 8027
- If multiple Forms 8027 required → submit Form 8027-T with batched Forms 8027
- 10 or more information returns → must file electronically through FIRE (to be retired after TY2026 → IRIS will become the only intake system)

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Form 8027: Penalties

P. 181

Failure-to-file and failure-to-furnish penalties may apply to an untimely or incorrect Form 8027

Waiver available for reasonable cause (not willful neglect)

De minimis rule [I.R.C. § 6721(c)]:

- **Timely filed** but incorrect/incomplete returns corrected before **August 1**
- No penalty on the **greater of** 10 returns or ½ of 1% of total information returns due

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Example 5.9: Completing Form 8027

PP. 181-182

- Cajun Bistro:
  - **Gross Receipts**: $820,000
  - **Reported Tips**: $62,320 ($9,800 indirect + $52,520 direct)
  - **8% threshold**: $65,600 ($820,000 x 8%)
  - Since reported tips **<** 8% threshold → must allocate to directly tipped employees (using 1 of the 3 methods)
  - **Allocable amount**: $3,280 ($65,600 - $62,320)
  - Employee's share of allocation reported in box 8 of W-2
  - **Figure 5.8** shows a completed Form 8027

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Voluntary Tip Compliance Agreements

P. 183

IRS agreements for industries where tipping is customary (restaurants, casinos)

Goal: Improve compliance through education rather than tip examinations

Three Agreements:

- **Tip Reporting Alternative Commitment (TRAC)**
- **Tip Rate Determination Agreement (TRDA)**
- **Gaming Industry Tip Compliance Agreement (GITCA)**

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Practitioner Note: Proposed SITCA program

P. 183

- Notice 2023-13 proposes the **Service Industry Tip Compliance Agreement (SITCA)**
- Intended to replace TRAC, TRDA, and EmTRAC
- **Will not** apply to gaming industry
- Uses point-of-sale and time/attendance systems to improve compliance
- Existing agreements continue, pending publication of final revenue procedure (IRS will not enter into any **new** TRAC, TRDA, or EmTRAC agreements as of 03/08/2023)

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TRAC: Tip Reporting Alternative Commitment

P. 183

- No tip rate required; the employer must:
  - Give each directly tipped employee a **written statement of charged tips** attributed to employee (at least monthly)
  - Provide a procedure for employees to **verify or correct** attributed tips
  - Adopt a method for **indirectly tipped employees to report** tips at least monthly
  - Prepare and process a **written statement** (at least monthly) **of all cash tips** attributable to each directly tipped employee's sales

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TRAC: Key Features

P. 183

- Covers all employees – no employee/employer agreement required
- Collective underreporting → tip examination possible, but only for the underreporting employees
- Employer commits to **quarterly education** for all tipped employees and new hires
- Compliance assures no IRS examination of prior periods

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Practitioner Note: EmTRAC

P. 183

- Employer Designed Tip Reporting (EmTRAC) is similar to TRAC
- Created for employers that want to submit their own educational programs and tip reporting procedures for IRS approval

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TRDA: Tip Rate Determination Agreement

P. 184

- IRS works with the employer to set tip rates for the employer's occupations
- TRDA Requirements:
  - At least 75% of employees who receive $20+ of tips per month must sign participation agreements to report at or above the determined rate
  - Nonparticipating employees continue to report to the employer actual tips they receive

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TRDA: Tip Rate Determination Agreement

P. 184

- If employees report below the rate → employer provides names, SSNs, job class, sales, hours, and reported tips
- Compliance assures no prior-period examinations
- No education requirement for TRDA

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TRDA: Payroll Treatment

P. 184

- Attributed tips for participating employees are treated as cash tips for payroll tax withholding and Form 941 reporting
- Actual tips of nonparticipating employees remain subject to withholding and FICA taxes

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Example 5.10: TRDA Employee Participation Requirement

P. 184

- Roma's Italian Restaurant met the TRDA's 75% participation requirement for 2025
- Participation dropped to 60% as of January 6, 2026 (despite good-faith efforts)
- Result → IRS can terminate Roma's TRDA
- Termination effective the first day of the first calendar quarter after written IRS notice

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GITCA: Gaming Industry Compliance Agreement

P. 184

- Promotes tip compliance in gaming industry
- IRS and employer establish minimum tip rates by occupational category
- General agreement term: 5 years (initial term may be shorter)

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GITCA: Gaming Industry Compliance Agreement

P. 184

- At least 75% of employees must sign a Model Gaming Employee Tip Reporting Agreement and report at or above the rate
- Below-rate reporting → employer provides employee details
- Compliance assures no prior-period exams

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P. 185

QUALIFIED TIPS AND OVERTIME DEDUCTIONS

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Qualified Tips and Overtime Deductions

P. 185

- OBBBA provides deductions for qualified tip income and qualified overtime compensation
- Available for tax years 2025 through 2028
- Claimed on **new** Schedule 1-A (Form 1040), Additional Deductions

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No Tax on Tips Deduction

P. 185

- Tips generally must be included in gross income and subject to payroll taxes
- Deduction of up to $25,000 for qualified tip income reported on one of: W-2, Form 1099-NEC, Form 1099-MISC, Form 1099-K, Form 4137 (unreported tip income)

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No Tax on Tips Deduction

P. 185

- **Final regulations [T.D. 10044]**: Statements furnished to a sole proprietorship or a single-member LLC are considered furnished to tip recipient owner – regardless of whose name appears as recipient

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Cross-Reference: Final Regulations

P. 185

- Final regulations under § 224 are effective **June 12, 2026**
- See the **"New and Expiring Legislation"** chapter for more on these final regulations

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No Tax on Tips: Limits and Eligibility

P. 185

- Available to both standard deduction and itemizing taxpayers
- **Not** available to MFS taxpayers
- **Phase-out**: $25,000 maximum reduced by $100 for every $1,000 of MAGI over $150,000 ($300,000 MFJ)

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No Tax on Tips: Limits and Eligibility

P. 185

- Valid SSN required; on a joint return, the spouse who received the tips must have a valid SSN
- **Final regulations**: $25,000 cap applies **per return** – same maximum applies regardless if it is an individual or joint return

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Qualified Tips

PP. 185-186

- **Qualified Tips**: Tips received from customers, or as an employee through a tip-sharing agreement
- Must be received in an occupation that customarily and regularly received tips on or before December 31, 2024

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Qualified Tips

PP. 185-186

Qualified tips must be: Cash tips, Paid voluntarily, Not the subject of negotiation, and Determined by the customer/payer

If the taxpayer earns tips in the course of a trade or business (other than performing services as an employee) the amount of qualified tips is subject to a business income limit

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Qualified Tips: Cash Tips

P. 186

- Cash
- Check
- Credit/debit card
- Gift card
- Tokens exchangeable for a fixed amount (casino chips)
- Electronic/mobile payments denominated in cash (not crypto)

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Qualified Tips: Cash Tips

P. 186

- Tips = the excess paid over the amount agreed to or reasonably expected for the services
- Cash tips **do not** include items paid in **any medium other** than cash. Examples include:
  - Event tickets
  - Meals
  - Services
  - Or assets not exchangeable for a fixed amount of cash

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Qualified Tips: Cash Tips

P. 186

- **Final Regulations**: Cash tips include amounts paid in foreign currency; **do not** include digital assets
- Tips reported under TRDA or GITCA **are** qualified tips if:
  - The employee is otherwise eligible for the deduction; and
  - The employee reports tips using the established rates
- Additional qualified tips may be reported on Form 4137

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Qualified Tips: Paid Voluntarily

P. 186

- Tips must be paid voluntarily, with no consequence for nonpayment
- Service charges, automatic gratuities, and other mandatory add-ons are **not** qualified tips
- **Exception**: these add-ons **can be** considered qualified tips if the customer has an express option to disregard or modify the charge without consequence

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Example 5.11 & 5.12: Voluntary Payment

P. 186

- **Example 5.11**: Green Oaks adds an automatic 18% gratuity for parties of 6+; customers cannot reduce it → **not** a qualified tip
- **Example 5.12**: Salon POS device prompts the customer with 15%/18%/20%/other/no tip → customer determines the amount = qualified tip

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Tips Earned in a Trade or Business

P. 187

§ 224(c): tips received in a trade or business ount toward the deduction only to the extent gross income from that trade or business (including tips) exceeds allocable deductions

The tip deduction itself is excluded from this calculation

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Not Qualified Tips: SSTB

P. 187

Tips received as an employee of a specified service trade or business (SSTB) are not qualified

Tips received by self-employed SSTB taxpayers in that trade or business are not qualified

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Practitioner Note: SSTB Determination

P. 187

- Until January 1 of the year after final SSTB regulations are issued, the IRS treats an employee as **not** working in an SSTB if the occupation is on the customarily tipped list **[Notice 2025-69]**
- Proposed regulations would have used the I.R.C. § 199A(d)(2) SSTB definition
- Final regulations reserve Treas. Reg. § 1.224-1(g) for future SSTB guidance

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Not Qualified Tips: Illegal Services

P. 187

- **Tips for services that are a felony or misdemeanor under applicable law are not qualified**
- Tips for **legal** service at an establishment that violates the law in other respects **may** be qualified
- **Marijuana**: Currently unlawful under federal law – if federal law and (some) state laws change, tips on those transactions **may** become qualified

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Example 5.13 & 5.14: Legality Tests

P. 187

- **Example 5.13**: Seth tends bar without the state-required certification (a misdemeanor) → his $15,000 of tips are **not** qualified
- **Example 5.14**: Karmela works as a concierge at a resort that lacks a required liquor license → her $15,000 of tips **are** qualified – her work is legal

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Customarily and Regularly Tipped Occupations

P. 188

- **A qualified tip must be paid in an occupation that customarily and regularly received tips on or before December 31, 2024**
- A Treasury Tipped Occupation Code (TTOC)
- Occupation title and description
- Illustrative examples and related Standard Occupation Classification (SOC) code(s)
- **See Figure 5.9**

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Qualified Tips: Form W-2 Reporting

P. 190

- **Code TP**: used in box 14 on employee's W-2 to report total amount of cash tips reported to the employee
- **Box 14b**: employer can report **up to two** TTOCs for the tipped occupations
- Taxpayer uses this information to figure the deduction in Part II of Schedule 1-A (Form 1040)
- If the only occupation code in box 14b is 000 → the cash tips **are not** qualified tips

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Cross-Reference: New Forms W-4 and W-2

P. 190

- See the "Payroll and Estimated Tax" chapter for a discussion on the new Form W-4 and the worksheet to reduce withholding for the qualified tips and overtime deductions
- The chapter also reviews the new Form W-2 and employer reporting for qualified tips and qualified overtime earnings

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Example 5.15: No Tax on Tips Deduction

P. 190

- **Facts**
  - Demetri & Raquel (MFJ, no dependents)
  - Demetri (bank employee): W-2 box 1 = $230,000
  - Raquel (server): $32,000 salary + $45,000 reported cash tips
  - Raquel's W-2:
    - Box 1: $77,000 ($32,000 + $45,000)
    - Box 7: $45,000
    - Box 12: Code TP and $45,000
    - Box 14b: Code 102 (wait staff TTOC)

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Example 5.15: No Tax on Tips Deduction

P. 190

- Demetri & Raquel MAGI: $307,000 ($230,000 + $77,000)
- MAGI exceeds $300,000 by $7,000 → qualified tip deduction reduced by $700 (7 x $100)
- Max qualified tip deduction: $24,300 ($25,000 - $700)
- $24,300 reported on line 13b of 1040
- Completed Schedule 1-A shown in Figure 5.10

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No Tax on Overtime

P. 192

Overtime compensation is included in gross income and generally subject to FICA taxes

↓

Deduction of up to $12,500 ($25,000 MFJ) of **qualified overtime compensation** paid in 2025-2028

↓

Overtime must be reported on W-2, 1099-NEC, or 1099-MISC

↓

Available with the standard deduction or itemizing; MFS taxpayers ineligible

↓

Phase-out: $100 per $1,000 of MAGI over $150,000 ($300,000 MFJ)

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Qualified Overtime Compensation Defined

P. 192

- Overtime **required** under § 7 of the Fair Labor Standards Act (FLSA)
- Only the amount above the regular rate – generally the **one-half portion of time-and-a-half**
- May appear on statements as "overtime premium" or "FLSA overtime premium"
- **FLSA basics**: covered, non-exempt employees must receive at least 1.5x the regular rate for hours over 40 per workweek

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Not Qualified Overtime Compensation

PP. 192-193

- **Premium pay**: amounts above time-and-a-half (e.g., under a CBA or state law)
- **Holiday/weekend pay**: extra pay when the employee does not work more than 40 hours in the workweek
- **Qualified tips**: never count as qualified overtime
- **State-law overtime**: overtime paid to FLSA-ineligible employees under state rules does not qualify

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Example 5.16: No Tax on Overtime Deduction

P. 193

- Facts:
  - Brian (FLSA-eligible)
  - W-2 box 1: $65,000
  - W-2 box 12: $5,000, code TT
  - Spouse Hilda's W-2 box 1: $237,000
  - Combined MAGI: $302,000
- MAGI exceeds $300,000 by $2,000 → overtime deduction reduced by $200

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Example 5.16: No Tax on Overtime Deduction

P. 193

- Max overtime deduction: $4,800 ($5,000 - $200)
- $4,800 transferred to line 13b of 1040
- **Figure 5.11** shows completed Schedule 1-A

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P. 194

QUALIFIED IMPROVEMENT PROPERTY

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P. 194

Qualified Improvement Property (QIP)

TCJA replaced qualified leasehold improvement, qualified restaurant, and qualified retail improvement property with a single definition: **qualified improvement property (QIP)**

Example: a restaurant remodeling its dining room may have QIP

QIP is eligible for bonus depreciation and § 179 expensing

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QIP: 15-Year Property

P. 194

QIP = any improvement to an **interior** portion of nonresidential real property, placed in service after the building was first placed in service [I.R.C. § 168(e)(6)]

Excludes:

- Enlargement of the building
- Elevators or escalators
- Internal structural framework

95

QIP: 15-Year Property

P. 194

15 years (straight line method) and half-year or mid-quarter convention

Qualifies regardless of whether the improvement is:

- Subject to a lease
- Placed in service more than 3 years after the building
- Made to a restaurant building

Restaurant building property that is **not QIP** → 39-year nonresidential real property (straight-line, mid-month)

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QIP: Legislative History

P. 194

- TCJA failed to designate QIP as 15-year property → by default these assets became 39-year property, ineligible for bonus depreciation or § 179 expensing
- CARES Act retroactively designated post-2017 QIP as 15-year property
- ADS life of QIP: 20 years

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QIP: Bonus Depreciation

P. 194

- TCJA bonus depreciation phase-down schedule: 40% (2025), 20% (2026), 0% (2027)
- **OBBBA**: 100% bonus depreciation made **permanent** for property acquired and placed in service **after January 19, 2025**
- **Election available**: 40% (instead of 100%) for qualified property placed in service in the first tax year ending after January 19, 2025
- No taxable income limit (unlike § 179)

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Electing Out of Bonus Depreciation

PP. 194-195

Taxpayers may elect out by property class – the election covers **all** property in that class placed in service that year

Attach a statement to a timely filed return (including extensions) identifying the class of property

Revocation of the election

- IRS consent
- **Exception**: automatic 6-month window to revoke election by amended return

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Practitioner Note: Notice 2026-11

P. 195

- **Notice 2026-11**: IRS plans proposed bonus depreciation regulations reflecting OBBBA; they will apply once finalized

100

Section 179

P. 195

- **2026 expensing limit**: up to $2,560,000 of qualifying § 1245 property
- **Phase-out**: dollar-for-dollar once property placed in service exceeds $4,090,000 (Fully phased out at $6,650,000)
- QIP is § 179-eligible regardless of lease status, 3-year rule, or restaurant use
- Non-QIP restaurant building property is **not** eligible

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Section 179: Income Limit

P. 195

- A § 179 deduction can reduce business taxable income to zero (but cannot create a loss)
- Excess elected amounts carry forward to future years
- Income limit measured before the § 179 deduction, the ½ SE tax deduction, and any NOL carryforward

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P. 196

COST SEGREGATION STUDIES

103

P. 196

Cost Segregation Studies: Overview

- Depreciable property often includes assets with different recovery periods
- Taxpayers must separate property into components/asset groups with the same recovery period and placed-in-service date
- Simple when component costs are known
- A lump-sum purchase price may require a cost segregation study to allocate costs

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Benefits of a Cost Segregation Study

P. 196

- Segregation studies are most commonly prepared for tangible personal property
- Tangible personal property (equipment, furniture, fixtures): often 5- or 7-year recovery – and may be eligible for § 179 expensing, bonus depreciation, and accelerated depreciation methods

105

Benefits of a Cost Segregation Study

P. 196

- Allocating more cost to personal property accelerates depreciation and reduces taxes
- Some tangible personal property relatively easy to identify; Studies can also identify **nonstructural building components** (carpeting, wall coverings, partitions, swinging doors) as separately depreciable property

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Practitioner Note: Audit Technique Guides

P. 196

ATGs give IRS examiners background and exam guidance; not official authority, but useful on legal framework

Cost Segregation ATG updated (02/2025) for Inflation Reduction Act changes, including:

- § 263A UNICAP rules, bonus depreciation, § 179D
- The detailed estimate approach and applicable penalties
- New industry-specific guidance for residential rental property

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Cost Segregation: Legal Guidance

P. 196

Hospital Corporation of America v. Commissioner (109 T.C. 21):

- § 168(f)(1) prohibition of component depreciation applies only to § 1250 property
- Investment tax credit tests [Treas. Reg § 1.48-1(e)] still apply to § 1245 property
- IRS acquiesced to the definition of personal property [AOD-1999-008], but not to the specific assets the court treated as tangible personal property

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Cost Segregation: Legal Guidance

P. 197

Whiteco Industries (65 T.C. 664) – factors to determine whether property is inherently permanent

- Is the property capable of being moved – and has it been?
- Was it designed or constructed to remain permanently in place?
- Do circumstances show the expected length of affixation?
- How substantial and time-consuming is removal?
- How much damage would removal cause?
- How is the property affixed to the land?

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Cost Segregation: Legal Guidance

P. 197

IRS Chief Counsel guidance in C.C.A. 1999-21-045

- No bright line test – facts and circumstances control
- The taxpayer must specifically apply a cost segregation study
- Allocations must rest on a "logical and objective measure" of § 1245 property
  - Noncontemporaneous records, reconstructed data, and unsupported estimates **do not** suffice
- Field agents should closely scrutinize cost segregation studies

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Cost Segregation Study Fees

P. 203

- Fees vary with building size, business type, building age, and other factors
- Taxpayers start with a feasibility study – do projected tax savings outweigh the study's cost?
- Study fees are deductible as § 162 business expense

111

Example 5.17: Cost Segregation Applied

PP. 203-204

June 2026 – Dae purchases a restaurant for $1.8 million

- **Land**: $180,000
- **Equipment and furniture**: $420,000
- **Building and structural components**: $1.2 million

Feasibility study estimates

- 5% of building ($60,000) → 15-year property
- 25% of building ($300,000) → 5-year property
- Remaining $840,000 → 39-year property

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Example 5.17: Cost Segregation Applied

PP. 203-204

- **Assumptions (using Pub. 946 tables)**: 35% marginal rate, 8% discount rate
- **Present value of tax savings over 39 years**: $79,587 (Figure 5.13)
- **Study fee**: $15,000 → after-tax cost $9,750 [$15,000 – ($15,000 x 35%)]
- **Net Savings**: $79,587 - $9,750 = $69,837

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Cost Segregation: Change in Accounting Methods

P. 205

- **Change** in depreciation method, recovery period, or convention is a change in accounting method
- **Reclassifying** building cost from § 1250 to § 1245 property after a cost segregation study
- **File Form 3115** under the automatic consent provisions of Rev. Proc. 2015-13, designated change number 8 [Rev. Proc. 2025-23]
- Adjusted basis does not change → no items duplicated or omitted, so no § 481(a) adjustment required

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P. 206

SAFE HARBOR FOR REMODEL AND REFRESH PROJECTS

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Remodel-Refresh Safe Harbor: Overview

P. 206

- **Rev. Proc. 2015-56**: safe harbor for certain retail and restaurant taxpayers
- These taxpayers can use a simple computation to determine portion of remodel-refresh project that is deductible as a repair and the portion that must be capitalized and depreciated as an improvement

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Remodel-Refresh Safe Harbor: Rev. Proc. 2015-56

P. 206

Taxpayers that elect the safe harbor may:

- Treat 75% of expenditures as an § 162(a) business deduction
- Must capitalize and depreciate the remaining 25% as
  - § 263(a) improvements or
  - § 263A production costs

Costs are eligible in the year the associated portion of the project is placed in service

Requirements: an applicable financial statement (AFS) + documentation of qualified costs

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Observation: No Detailed Analysis Is Required

P. 206

- The safe harbor minimizes the need for a detailed repair-vs-improvement analysis of each cost
- Because it applies to the entire building or leased space, it also eliminates applying the improvement and unit-of-property rules separately to each building structure and building system

118

Applicable Financial Statement (AFS)

P. 206

AFS is defined (in descending priority) as one of the following:

- A financial statement filed with the SEC
- A certified, audited financial statement with an independent CPA's report, used for credit, reporting to owners, or another substantial nontax purpose
- A financial statement (other than a tax return) required by federal or state government or agency (other than SEC or IRS)

Group AFS: a taxpayer reporting on a group AFS may treat the group's AFS and written accounting procedures as its own

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Qualified Taxpayer Requiring AFS

P. 207

- Sells merchandise to customers at retail (including warehouse clubs and home improvement stores); or
- Prepares and sells meals, snacks, or beverages for immediate on-premises or off-premises consumption; or
- Owns or leases a qualified building to a qualified taxpayer operating an eligible retail or restaurant business

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Observation: Eligible NAICS Codes

P. 207

- Retailers: NAICS codes 44 or 45
- Restaurants: NAICS code 722
- Ancillary services **do not** disqualify a retailer or restaurant
- The taxpayer's **primary** business activity determines eligibility

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Industries Ineligible for Safe Harbor

P. 207

- Automobile and other motor vehicle dealers;
- Manufactured home dealers;
- Gas stations;
- Non-store retailers
- Hotels and motels
- Civic or social organizations
- Amusement parks and theaters
- Casinos
- Country clubs or other similar facilities
- Special food services such as caterers and mobile food services

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Qualified Building

P. 207

Each building unit of property and building system used primarily for:

- Selling merchandise to retail customers; or
- Preparing and selling food or beverages for immediate on- or off-premises consumption

Includes cooperatives, condominiums, and leased buildings

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Practitioner Note: GAA Election and Partial Dispositions

P. 207

- See Rev. Proc. 2015-56 for general asset account (GAA) requirements and the resulting prohibition on partial disposition elections under Treas. Reg. § 1.168(i)-8(d)(2)

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Remodel-Refresh Project Defined

PP. 207-208

Alter the physical appearance or layout of a qualified building to:

- Maintain a contemporary and attractive appearance
- More efficiently locate retail or restaurant functions and products
- Conform to current building standards and practices
- Standardize the customer experience (multiple buildings)
- Offer the most relevant and popular goods in the industry
- Address demographic changes in offerings and presentation

125

Observation: Repainting and Cleaning Projects

P. 208

A project **solely** to repaint or clean the interior or exterior is **not** a remodel-refresh project

Those costs are generally deducted as repairs under the final regulations

Painting done in conjunction with other activities **may** qualify as a remodel-refresh activity

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Qualifying Remodel-Refresh Activities

P. 208

- Painting, polishing, or finishing interior walls
- Adding, replacing, repairing, or relocating flooring, ceilings, wall coverings, (incl. millwork), or kitchen fixtures
- Adding, replacing, or modifying signage or fixtures
- Relocating or resizing departments, eating areas, check-out areas, kitchens, beverage areas, management or storage space (within existing footprint)

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Qualifying Remodel-Refresh Activities (cont'd)

P. 208

- Adding, relocating, or removing rooms; moving, constructing, or altering walls (within existing footprint)
- Lighting work: adding, relocating, removing, or relamping fixtures; adding reflectors or mirrors
- Building systems work within the existing footprint

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Qualifying Remodel-Refresh Activities (cont'd)

P. 208

- Nonstructural façade changes; relocating, replacing, or adding windows and doors
- Roof repair, maintenance, or replacing within the existing footprint

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Qualifying Remodel-Refresh Activities (cont'd)

P. 208

- Replacing facade material around windows and entrances
- Repair and maintenance that directly benefits, or is incurred by reason of, a remodel-refresh project
- Removing/demolishing structural components (other than § 280B demolitions – more than 25% of external walls **and** internal structural framework)
- Permits and similar authorizations; architectural and engineering services tied to the project

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Excluded Remodel-Refresh Costs

P. 209

- § 1245 property
- Intangible assets (including computer software)
- land and land improvements (sidewalks, parking lots, depreciable landscaping)
- Initial acquisition, production, or lease of a qualified building (purchase price, construction, transaction costs, pre-placed-in-service work)

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Excluded Remodel-Refresh Costs (cont'd)

P. 209

- Initial build-out for a new lease
- Rebrand/refresh/remodel within 2 tax years after acquiring (or initially leasing) the building or acquiring a controlling interest
  - including by related parties [I.R.C. §§ 267(b), 707(b)]
- Ameliorating a pre-existing material condition or defect (whether or not known at acquisition)
- Material additions to a qualified building (including building systems)

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Excluded Remodel-Refresh Costs (cont'd)

P. 209

- Casualty-related restoration where basis was reduced under § 165
- Adapting more than 20% of total square footage to a new or different use (measured pre-project)
- Costs paid or incurred during a temporary closing (closed during normal business hours for more than 21 consecutive calendar days)
- Property for which the taxpayer elected § 179, § 179D, or § 190 deductions

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Practitioner Note: Material Additions Defined

P. 209

- Material additions include:
  - Enlarging, expanding, or extending square footage of a qualified building; or
  - Enlarging, expanding, or extending the building systems in conjunction with extending the square footage of a qualified building

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Qualified Costs and Documentation

PP. 209-210

- **Total qualified costs** = remodel-refresh costs – excluded remodel-refresh costs
- **Appendix A of Rev. Proc. 2015-56**: required documentation for remodel-refresh costs
- **Appendix B**: example reconciliation of financial statement fixed assets to total qualified costs

135

Cross-Reference: I.R.C. § 1245 Property Excluded

P. 210

- § 1245 property is excluded from the definition of qualified property
- Taxpayer should consider a cost segregation study of the remodel-refresh activity to identify qualified expenditures

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Using the Safe Harbor Method

P. 210

- Change in accounting method: file Form 3115 under the automatic-consent provisions
- The change requires an I.R.C. § 481(a) adjustment
- An electing taxpayer must apply the safe harbor to **all** qualified costs on **all** remodel-refresh projects for each year

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Tax Treatment of Nonqualified (25%) Costs

P. 210

Taxpayer may be able to treat the 25% of nonqualified costs as QIP which is:

- Subject to a 15-year recovery period OR
- Eligible for § 179 expensing and bonus depreciation

Rev. Proc. 2020-25: the capital expenditure portion is QIP to the extent the taxpayer can **substantiate it**

Amount not qualifying as QIP → 39-year nonresidential real property

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P. 211

RESTAURANT SMALLWARES SAFE HARBOR

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P. 211

Smallwares Safe Harbor: Background

- **Individually inexpensive items used to prepare, serve, and store food and beverages (pots, pans, dishes, silverware, linens, small appliances, glassware)**
- Average useful life is slightly over a year

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Smallwares Safe Harbor: Background

P. 211

- **Rev. Proc. 2002-12** resolves the § 162 expense vs. § 263(a) capitalization dispute
- Restaurants and taverns may immediately expense smallwares under the safe harbor

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Practitioner Note: Start-up Expenditures

P. 211

- The smallwares safe harbor **does not** apply to start-up expenditures
- An opening smallwares package bought by a taxpayer **not** already operating a restaurant or bar is an I.R.C. § 195 start-up expenditure
- Up to $5,000 of start-up costs deductible – reduced by the amount start-up expenditures exceed $50,000
- Nondeductible start-up expenditures are amortized over a 15-year period beginning the month the business opens

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Smallwares Method

P. 211

- Smallwares are treated as nonincidental materials and supplies [Treas. Reg. § 1.162-3]
- Deductible in the year consumed or used in the business
- "Consumed and used" when received and **available for use** at the restaurant
  - Items stored at a warehouse or other facility do not count until moved to the restaurant
- Applies to opening packages for new locations **and** replacement items at existing locations

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Business of Operating a Restaurant or Tavern

P. 211

The taxpayer must prepare food and beverages to customer order for immediate on- or off-premises consumption including:

- Full-service restaurants
- Limited-service eating places & cafeterias
- Special food services (food service contractor, caterers, mobile food)
- Food/beverage services at grocery stores, hotels, amusement parks, theaters, casinos, country clubs
- Bars, taverns, and other drinking places

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Smallwares Defined

P. 212

Ten categories:

1. Glassware and paper/plastic cups
2. Flatware and plastic utensils
3. Dinnerware and paper/plastic plates
4. Pots and pans
5. Table-top items (shakers, tablecloths, napkins, menus, vases, candles)

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QUESTIONS?????

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