

TIPS AND SERVICE CHARGES

A tip is a sum a customer gives as a gift or gratuity in recognition of some service performed. Whether a tip is given, and how much, is determined solely by the customer. Generally the customer has the right to determine who shall be the recipient of the tip.

In the absence of an agreement to the contrary, such as a tip pooling arrangement referred to later in this chapter, a tip becomes the property of the employee to whom it is given.

Tips cannot be used to pay for uniforms or to reimburse management for shortages, breakage, walkouts, or other establishment losses.

SERVICE CHARGES

A service charge, on the other hand, is an amount added to a customer's bill by management. It is important that the customer be informed of the service charge and the amount thereof prior to ordering, either by a conspicuous notice on the menu or some other means.

Under federal law, service charges belong to the establishment, become a part of the establishment's gross receipts and may be retained by management or distributed to employees in any amount management chooses.

Service charges distributed to employees are treated as wages and thus may be used to satisfy an employer's obligation to pay workers the minimum wage. However, even if distributed to employees, service charges cannot be used for the purpose of taking a tip credit.

EMPLOYEE TIP REPORTING

Employees' Daily Records

All employees receiving tips must keep a daily record or other evidence of the tips they receive. The daily record should show the employee's name and address; the employer's name (and, if different, the establishment name); the amount of cash and charge tips received directly from customers and from other employees; the amount of tips paid to other employees; and the names of the other employees to whom the employee paid tips.

While no particular form of daily record is prescribed, IRS Form 4070-A, Employee's Daily Record of Tips, is recommended.

Employee Reports of Tips to Employers

Any employee who receives tips of at least \$20 per month must furnish their employer a written statement of all tips received (cash as well as credit card) by the 10th day of the month following the month in which the employee received the tips. That requirement includes directly tipped employees, such as servers, as well as indirectly tipped employees, such as buspersons.

The employer may require that such statements be furnished more frequently. Many operators have found, for example, that these statements are more likely to reflect all tips received if required daily.

The written statement should be signed by the employee and should disclose:

- The date the statement was furnished.
- The employee's name, address, and social security number.
- The employer's name and address.
- The period the statement covers, specifying exact dates (e.g., "April 1998," "April 4 through April 11, 1998," etc.).
- Total tips the employee received during that period.

As long as all the above information is included, the IRS prescribes no particular form. However, IRS Form 4070, Employee's Report of Tips to Employer, is recommended.

Employees are required to report only the tips they keep; servers who "tip out" or contribute to a tip pool, for example, should report only the tips they retain.

Employees' Failure to Report Tips

As noted above, tip reporting laws require directly- and indirectly tipped employees to report all tips they receive (and keep) to their employer. The law does not make the employer responsible for reporting tips for employees, nor does it authorize the employer to allocate or assign to tipped employees tips equal to a certain percentage (8% or otherwise) of the tipped employees' sales.

Since all tip income is taxable, however, it is suggested that the employer remind employees of their obligation to report all tips received, cash as well as charged tips.

Unreported tips may cause problems for employers and employees later. Since early 1991, using data from employers' records and a formula called the "McQuatter's Formula for Tip Rate Calculation," the IRS has been auditing and billing employers for FICA taxes on previously unreported tips. The IRS does have the authority to collect back FICA taxes on unreported tips, since all tips received are taxable for FICA purposes, whether or not they are reported.

Note: Some employers believe they have a "safe harbor" from IRS scrutiny if employees report tips of at least 8% of sales. This is erroneous. Using the McQuatter's formula to estimate actual tip rates, the IRS has sent such employers huge bills for FICA taxes on unreported tips above the 8%.

Employees who fail to report tips are also inviting problems later with the IRS. For example, not only would the employees be liable for the tax due on such unreported tips, but they also could be assessed a penalty of up to 50% of the taxes that are due.

Tip Reporting Alternative Commitment

Since June 1, 1995, the IRS has been using a tool to try to improve tip reporting among restaurant employees as well as tipped employees in other industries.

The Tip Reporting Alternative Commitment, or TRAC, is an agreement that would be signed by both the employer and the IRS. Generally, an employer who signs the TRAC agrees to:

- 1) Establish an educational program with respect to the tip reporting requirements of newly hired and existing employees;
- 2) Keep a record of all charge tips by employee; and
- 3) Establish a procedure whereby:
 - a. Each directly tipped employee is provided with a written statement of charged tips attributed to him or her;
 - b. Each directly-tipped employee is given the opportunity to verify or correct the charged tips attributable to him or her to reflect tip-outs, tip sharing, tip pooling, and other adjustments; and
 - c. Each directly as well as indirectly tipped employee provides the employer with a written and signed statement of the charged as well as cash tips received by him or her.

In return, the IRS promises it will not bill an employer for FICA taxes on unreported tips while the TRAC is in effect without first determining that individual employees owe FICA taxes on unreported tips.

**** Tips on Tips ****

Call the IRS hotline at (800) TAX-FORM for copies of any of the following:

- IRS Form 4070A, Employee's Daily Record of Tips. Helps employees keep track of daily tips
- IRS Form 4070, Employee's Report of Tips to Employer. Employees can use this form to report tips to employers once a month.
- IRS Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips. Filed annually by large food and beverage establishments.
- IRS Publication 531, Reporting Income From Tips. Explains reporting laws to tip-earners.

EMPLOYER REPORTS OF TIPS TO THE IRS

Employers must file an IRS Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, for each calendar year with respect to each large food or beverage establishment. Returns are due on or before the last day of February following the end of the calendar year for which the information is being reported.

Which Operations Must File the 8027?

As stated above, the law requires that a Form 8027 be filed for "each large food or beverage establishment."

This covers any food or beverage operation where tipping is customary; which provides food and beverages for consumption on the premises; and which normally employs more than ten full-time employees (tipped and non-tipped) or their equivalent (80 employee hours) on a typical day. Food and beverage establishments with wide seasonal fluctuations can compute the employee threshold by averaging employee hours during the calendar month in which food and beverage sales were the greatest with those in the calendar month when sales were the least (not zero).

A separate 8027 should be filed for each food and beverage operation that meets the above criteria. In the case of an employer who conducts food and beverage operations at more than one location, for example, or at different locations within a single building (e.g., a gourmet restaurant, coffee shop and

cocktail lounge in a hotel), each location is a separate food and beverage operation if gross receipts for each location are recorded separately. A separate 8027 should be filed for each such operation that has a separate employer identification number.

If more than one 8027 is filed, an IRS Form 8027-T, Transmittal of Employer's Annual Information Return of Tip Income and Allocated Tips, must also be filed. Employers who file 250 or more Forms 8027 with the IRS each year must file these forms on magnetic media or in other machine-readable form. For information, call the IRS at (800) TAX-FORM and request a copy of Publication 1239, Employer's Annual Information Return of Tip Income and Allocated Tips on Magnetic Tape and 5¼" or 3½" Magnetic Diskettes.

The Tip Allocation Process

The 8027 requires employers to report to the IRS the establishment's food and beverage sales, as well as the total tips (cash and charged) that employees reported to the employer.

If total tips reported by employees are less than 8% of the establishment's food and beverage sales (not counting carryout sales and sales to which a service charge of 10% or more is added), the employer is required to "allocate" the difference among all directly-tipped employees who reported less than 8% of their share of the restaurant's sales.

Allocation is done either on the basis of a "good faith" agreement between employers and employees, or, if there is no such agreement, on the basis of IRS-prescribed allocation rules. Allocated tips must then be shown on employees' W-2 Forms.

If total tips reported exceed 8% of the establishment's food and beverage sales (not counting carryout sales and sales to which a service charge of 10% or more is added), no allocation is required.

What's a Good Faith Agreement?

A good faith agreement is a written agreement between the employer and at least two-thirds of the tipped employees of each occupational category (e.g., servers, busspersons, maitre d's) providing for a good faith approximation of the actual distribution of tip income among the tipped employees.

A good faith agreement takes effect only after the date of adoption, and has no retroactive effect. Employers who use a good faith agreement to allocate tips must attach a copy of the agreement to the 8027.

Allocation in the Absence of a Good Faith Agreement

If there is no good faith agreement in effect, employers who are required to allocate tips must do so according to IRS rules set forth in the Form 8027 instructions.

Establishments with fewer than 25 full-time employees or the equivalent thereof (on average, less than 200 employee-hours a day during the payroll period) may allocate tips according to either the gross receipts attributable to directly-tipped employees, or the hours worked by these employees.

Establishments with 25 or more full-time employees or their equivalent (more than 200 employee-hours a day, on average) must allocate tips according to the gross receipts attributable to directly tipped employees.

The 8% threshold can be reduced (but not below 2%) upon petition of either the employer or a majority of the employees. The petition should be filed with the district director of the Internal Revenue district in which the establishment is, or the greatest number of establishments are, located.

Penalties for Failure to File the 8027

IRS regulations provide for a penalty of \$50 for each 8027 not filed in a timely manner. However, the penalty may be substantially higher if the failure is due to an employer's intentional disregard of the filing requirements.

TIP CREDIT

The Fair Labor Standards Act (FLSA) requires that an employer pay employees at least the minimum wage prescribed by law. The same law permits employers in states that follow the federal tip credit to take a tip credit equal to the difference between the minimum wage and the cash wage of \$2.13 per hour.

Requirements for Taking a Federal Tip Credit

Employers may not take the federal tip credit unless the following requirements are met:

1. A tip credit can be taken only against the wages of employees who customarily and regularly receive at least \$30 per month in tips.
2. The amount of the credit claimed can never be more than the employee actually received in tips or more than the prescribed percentage of the applicable minimum wage. To the extent that the tips received by an employee are less than the permitted tip credit, the employer must pay the employee the difference between the tips reported and the minimum wage.
3. The employer must notify tipped employees of the amount of tip credit taken. No particular form of notice is required, but a posted notice or a notice on the employee's paycheck such as "Management is taking a tip credit of \$____ per hour as permitted by law," would suffice.
4. Employees must be allowed to retain all of their tips. This requirement prevents the employer from retaining any of the tips or using any of the tips to pay for such things as uniforms, breakage or losses. This requirement does not prevent tip-pooling arrangements, discussed at length later in this chapter.
5. The employer must be able to prove that the employee received tips in an amount at least equal to the amount of the tip credit claimed. Employees' written statements are the best proof of tips received.

Tip Credit for Incidental Work

Can an employer take a tip credit for the time a server spends cleaning and setting tables, toasting bread, making coffee, or occasionally washing dishes? In an opinion letter, the U.S. Department of Labor (DOL) stated that the tip credit can be taken for the time spent on such general preparation work.

However, the DOL takes the position that if servers are routinely assigned maintenance duties, such as floor cleaning, or if they spend more than 20% of their time performing general preparation work or maintenance, this is not tipped employment and the tip credit may not be taken for time spent on such work.

It is an open question as to whether or not the tip credit may be taken for time a server spends setting up a salad bar, for example, or performing other duties not mentioned in the opinion letter. Answers to those questions can be obtained only by requesting an opinion letter from the DOL.

Tip Credit for Dual Jobs

When an employee works at two jobs, one of which is tipped (such as a server or bartender) and the other not (such as host/hostess or cashier), DOL regulations are clear. The tip credit can be taken only for the time worked as a tipped employee.

TIP POOLING

The FLSA says employers may not take a tip credit unless an employee retains all of his or her tips. This does not, however, prevent tip-splitting or tip-pooling arrangements among employees who customarily and regularly receive tips, provided the participants are not required to contribute a greater percentage of their tips to the pool than is customary or reasonable.

Employers often ask whether it is possible for management to run a tip pool or participate in operating one. The answer is a qualified “yes” -- but employers should pay close attention to the following DOL guidelines on tip pooling:

1. The requirement that an employee retain all tips does not prevent tip-splitting or tip-pooling arrangements among employees who customarily receive tips. The following occupations have been recognized as falling within the eligible category: bellhops, waiters and waitresses (including cocktail servers), counter personnel who serve customers, busepersons, and service bartenders.

It is not required that busepersons or others who share in tips receive tips directly from customers. Both the amounts retained by the servers, for example, and those given to busepersons are considered the tips of the individual who retains them.

2. A valid tip-pooling arrangement cannot require servers to contribute a greater percentage of their tips than is customary and reasonable. For enforcement purposes, the DOL will not question pool contributions that do not exceed 15% of the employee’s tips. However, only tips in excess of the tip credit may be taken for the pool.

If conditions (1) and (2) are met, the tip pool may be set up and supervised by the employer; it does not require the voluntary consent of employees involved. DOL policies also clarify the following regarding management-supervised tip pools:

Tipped employees may not be required to share their tips with employees who have not customarily and regularly participated in tip-pooling arrangements. Examples include: janitors, dishwashers, chefs, cooks and laundry room attendants.

In the case of hosts/hostesses, headwaiters and seaters/greeters, the type of establishment and local practices will determine whether or not such persons can participate in a tip pool.

In requiring even as a general principle that tipped employees retain all their tips, it does not appear that Congress intended to prevent tipped employees from exercising a free choice in deciding what to do with their tips. This includes the sharing of tips with co-workers of their choice in any amount they please.

When a tip pool established by the employer includes ineligible employees, the employer must reimburse those who contributed to the pool in an amount equal to the tips turned over to the ineligible employees, and it may not seek reimbursement from ineligible employees.

CREDIT CARD TIPS

Where tips are charged on a credit card and the employer must pay the credit card company a percentage of this bill for use of its credit facilities, DOL will not question a practice whereby the employer reduces the amount of credit card tips paid over to the employee by an amount no greater than that charged by the credit card company.

For example, when a credit card company charges an employer 5% on all charge sales for use of its credit facilities, paying the employee 95% of all tips charged will not result in a violation of the law. However, the 95% of tips owed to the employee must be paid no later than the next regular payday and may not be held by the employer while he is waiting to be reimbursed by the credit card company.