



# Guide to laws and regulations for restaurant owners

## *TIPS AND TAXES*

### What is a tip?

A tip is an amount, totally at the discretion of the customer, given to an employee for prompt, courteous service.

### Who is a tipped employee?

*Wisconsin law* defines a tipped employee as any employee in an occupation in which he or she customarily and regularly receives tips from patrons or others.

*Federal law* defines a tipped employee, for minimum wage purposes, as any employee engaged in an occupation in which he or she customarily and regularly receives more than \$30 per month in tips. (\$20 per month for IRS tip reporting purposes.)

### What is a tip credit ?

A tip credit, or “tips deemed to be wages,” is the amount of reported tips that the employer may use to offset the minimum wage. Employers currently may use a tip credit of \$4.92 per hour for most employees and \$3.77 per hour for employees subject to the opportunity wage rate. *The rates below reflect the current state/federal minimum wage and must be adjusted whenever the minimum wage changes.*

	Wi. & Fed. Min. Wage	=	Tipped Employee Base Wage	+ Tip Credit
Regular wage	\$7.25	=	\$2.33*	+ \$4.92
Opportunity wage (see “Minimum Wage” guide for definition)	\$5.90	=	\$2.13	+ \$3.77

\* The federal cash wage for adult tipped employees is \$2.13, however Wisconsin’s rate of \$2.33 is more favorable for employees and is the rate that should be used.

### Employees not reporting enough tips to meet the tip credit

If the employee does not report earning enough tips, in a given pay period, to equal the tip credit, the employer cannot take a full credit. The employer must increase the base wage of the employee until the employee’s reported tips and base wage together equal the required minimum wage for that pay period.

### Tip declaration and “substantial evidence” requirements

*Wisconsin law* requires an employer taking a tip credit to:

- have a tip declaration signed by the tipped employee each pay period
- show on the payroll records that the combined wages and tips for each employee constitute at least the minimum wage
- show that required social security and other taxes have been withheld.

*Federal law* requires the employer to be able to present “substantial evidence” to support the validity of the amount of tips received by the employee and the tip credit taken, as well as required social security and other taxes being withheld.

Employers must also notify the employee that a tip credit is being taken. In the spring of 2011, the federal Department of Labor issued specific requirements about the notification that must be provided to tipped employees before the employer may use the tip credit:

- amount of direct base/cash wage to be paid to the employee (in Wisconsin the minimum base/cash wage is

**Questions? Call the WRA Hotline: 1-800-589-3211**

Revised March 2012



## Guide to laws and regulations for restaurant owners

# TIPS AND TAXES (CONTINUED)

\$2.33 an hour)

- Amount the employer claims as a tip credit (e.g. the difference between \$2.33 and \$7.25 an hour)
- The tip credit can't exceed actual tip earnings
- Employers can't claim the federal tip credit unless they inform employees of the federal law's provisions on the tip credit
- The law requires that employees retain all their earnings, with the exception of contributions to valid tip pools (more on tip pools below)

While this notification can be done verbally, it is strongly recommended that employers provide written notice, to make the evidence of their compliance indisputable. WRA created a basic template that you can use for this purpose. You are responsible for informing each employee of their specific base/cash wage and the amount of tip credit being taken. This information may vary from employee to employee within in a business. The "Tip Credit Employee Notification" form is in the Frequently Used Forms Section of the HERO and online in Members Only.

### Tip reporting

Because of the importance of honest, accurate tip reporting, the employer should monitor an employee's tip reporting on a regular basis. Employees are required by law to report 100 percent of their tips. Employees who do not properly report their tips can be disciplined.

Tip reporting can be used as an effective way of evaluating employee performance: tips which are consistently below those of other employees may represent poor customer service.

### Whose property are tips?

Generally, tips are the property of the employee who received them.

### Tip pooling

Tips belong to the employees. Therefore, employees must agree among themselves to pool tips and must be responsible for handling all money, with one exception: employers may require employee's tips to be pooled without the employee's consent as long as that amount does not exceed a percentage of tips that is "customary and reasonable." In the past, the NRA and WRA had advised employers that the federal Department of Labor would consider tips pools with a maximum threshold of 15% to be valid. Now, the law does not impose a maximum contribution percentage, so that percentage is up to the employer. You must notify your employee how much they will be required to contribute to the tip pool.

Mandatory, management-run tip pools shall include only "front of the house" personnel. Eligible employees include bellhops, waitstaff (dining and cocktail), bus-boys, bartenders, captains, hostesses and counterpersons who serve customers.

Tipped employees may not be required to share their tips with customarily untipped kitchen employees such as dishwashers, chefs, cooks or janitorial staff unless those employees do some waiting or bussing.

Employers who illegally require invalid tip pools can lose their rights to take a tip credit for any tipped employee. A penalized employer will have to pay the full minimum wage for every employee.

### What about service charges?

Generally, service charges are not tips for the purposes of either state or federal law. Unlike tips, which are given directly to the employee by the customer, a service charge is deemed to be the property of the employer because it is a required payment. The Wisconsin Department of Revenue requires that sales tax be collected on service charges.

**Questions? Call the WRA Hotline: 1-800-589-3211**

Revised March 2012



## Guide to laws and regulations for restaurant owners

# **TIPS AND TAXES** (CONTINUED)

Service charges distributed to employees must be reported as wages, not tip income, and should be distributed through the regular payroll system. This income must be reported as straight-time pay and may not be used to satisfy overtime pay obligations.

### **Charged tips**

The IRS recommends that charged tips be distributed through the regular payroll process with taxes withheld, rather than directly to the employee as cash. These are not regular wages, but are classified and treated as tips.

### **Set-up/clean-up time**

In general, an employer should be able to take a tip credit for all hours worked by an employee, even though no tips are earned during the set-up and clean-up times, as long as those job assignments are a legitimate part of the overall assignment of being a waiter or waitress and do not constitute a different job description, such as janitorial, etc. However, federal and state law differ on the amount of time that may be spent in non-tip producing duties.

If your business is subject to Wisconsin and federal law the Department of Labor generally allows 20 percent of the workweek to be spent doing incidental work that is non-tip producing.

If you are subject to Wisconsin law only the Department of Workforce Development generally accepts 1/3 of a shift to be spent performing legitimate set-up or clean-up assignments in conjunction with the waitstaff job.

### **Payroll taxes and deductions**

#### **FICA (social security tax)**

All reported tips are subject to both FICA taxes paid by the employee and FICA tax contributions paid by the employer.

#### **FUTA (federal unemployment compensation tax)**

All reported tips are subject to FUTA.

#### **Wisconsin UC (state unemployment compensation tax)**

All reported tips are subject to Wisconsin UC tax

#### **Priority of withholding taxes**

It is possible that there may not be enough cash wages available on an employee's paycheck to pay the taxes due on the cash wages plus tips reported. Therefore, there is a priority in withholding taxes:

1. Employee's share of social security on cash wages (exclusive of tips).
2. Federal income tax on cash wages (exclusive of tips).
3. State withholding on cash wages (exclusive of tips).
4. Employee's share of social security on tips.
5. Federal income tax on tips.
6. State income tax on tips.
7. Balance due on taxes carried forward from previous paychecks.
8. Other payroll deductions.

**Questions? Call the WRA Hotline: 1-800-589-3211**

Revised March 2012



## Guide to laws and regulations for restaurant owners

# TIPS AND TAXES (CONTINUED)

Any balance of taxes due is carried forward to be taken out of future checks. However, the employer may receive money from the employee to pay those taxes.

### Meals and lodging

*Wisconsin law* provides that deductions for meals and lodging may be made only for bona fide meals consistent with the employee's work shift. No deductions can be made or credit given for meals not eaten except in employment where weekly room and board is provided and accepted. An employer cannot require that meals be accepted as partial payment of wages.

When meals and/or lodging are furnished by the employer and accepted by the employee, a credit, not to exceed the following amounts, may be deducted from wages:

*Lodging* -- for non-opportunity wage employees, \$58.00/week or \$8.30 day. For opportunity wage and minor employees, \$47.20/week or \$6.75/day.

*Meals* -- for non-opportunity wage employees, \$87.00/week or \$4.15 meal. For opportunity wage and minor employees, \$70.80/week or \$3.35/meal.

### IRS employee tip reporting requirements

#### How much tip income is an employee required to report?

Federal law and the IRS require tipped employees to report 100 percent of their tips. If they do not report all tips, they are breaking the law. The employer is required to inform the employee that the law requires them to report all of their tips. However, it is not the responsibility of the employer to enforce this law beyond informing and filing required reports with the IRS.

**Questions? Call the WRA Hotline: 1-800-589-3211**

### Substantiation of tipped income

An employee is required to maintain "sufficient evidence" to establish the amount of tip income received. That evidence consists of either a daily tip record or other evidence of daily tip income received that is "as credible and reliable as daily record."

IRS form 4070A, Employee's Daily Record of Tips, may be used. Each entry must be made on or near the day the tip is received.

The IRS says "other evidence" should consist of documents such as copies of restaurant bills or credit card charges that show the amount of tips added to checks by customers or amounts from which tips are paid. In case of an audit, it is in the employer's best interest to have seven years in back records to establish a clear picture of actual income.

### IRS employer tip reporting requirements

#### IRS Form #8027: Employers Annual Information Return on Tip Income and Allocated Tips

Some restaurants, but not all, are required to file IRS Form #8027, Employers Annual Information Return on Tip Income and Allocated Tips. On the form, employers must list the business's annual gross sales (explained on next page) and the total amount of tips reported by all tipped employees for the year.

The total of reported tips on the #8027 must be at least 8 percent of total reported sales. If reported tips do not equal 8 percent of sales, the restaurant must "allocate" on to individual tipped employee's W-2 forms enough in



## Guide to laws and regulations for restaurant owners

# TIPS AND TAXES (CONTINUED)

unreported tips to bring the overall amount of tips up to 8 percent of sales. The allocation is not an additional amount due to the employee. Rather, it is an amount the IRS assumes the employee should have reported and paid taxes on.

### Who must file IRS form #8027?

Only employers of “covered establishments,” as defined on the next page, must file Form #8027. However, if you receive a request for a Form #8027, even though you are exempt, you must respond by sending a copy of the request and an attached statement explaining why you believe you are exempt, including your calculations as shown on the next page.

**All #8027 forms are typically due February 28 of each year. Electronic filings are due later.**

### Covered establishments

Food and beverage establishments where tips are *customarily* received and which employ more than 10 employees (not only tipped employees) on a typical business day must file Form #8027.

- “Ten employees on a typical business day” is defined as 80 employee hours.
- All establishments under the same ownership must be considered together for the 10 employee/80 employee hours test.
- Management, staff and any employee who owns 50 percent or more in value of stock of a corporation operating an establishment may be excluded when computing employee hours.

To determine the number of employee hours on a “typical” business day, you may average a typical day in your best month with a typical day in your slowest month.

**Example:** Best month - December  
Employee hours worked: 5,000  
Days open: 29  
 $5000 \text{ divided by } 29 = 172 \text{ average hours per day}$

Slowest month - April  
Employee hours worked: 1330  
Days open: 30  
 $1330 \text{ divided by } 30 = 44 \text{ average hours per day}$

Total hours per day for both months:  
 $44 + 172 = 216$   
 $216 \text{ divided by } 2 = 108$   
Average hours per day is 108

Thus, this establishment is covered because the number of employee hours on a typical business day exceeds 80.

### Determining gross sales

For the purpose of determining 8 percent of gross sales, whether allocation is necessary and in what amount, some parts of the operation may be exempted.

The following may be deducted from gross sales:

- Sales tax.
- Sales of non-food items.
- Carry-out sales - a good faith estimate of carry-out trade as a percentage of total sales is sufficient if sales are not recorded separately.
- Employee meals that are recorded.
- Discounts or coupons if rung up as part of gross sales.
- Free beverages or meals.
- Sales on which a mandatory service charge of 10 percent or more is assessed. (“Service charge” means an amount negotiated in advance or of which the customer is informed in advance, and is mandatory and not at the discretion of the customer. Whether or not any part of it is paid out by the employer to the employee is not relevant for this purpose. See the section on service charges.)
- Sales from separate functions of the establishment

**Questions? Call the WRA Hotline: 1-800-589-3211**

Revised March 2012



## Guide to laws and regulations for restaurant owners

# TIPS AND TAXES (CONTINUED)

where *tips are not customarily received* such as a bar, buffet, etc. may be exempt if gross receipts are recorded separately for each such function. (If the bar is to be exempt because employees are not customarily tipped, cash sales over the bar must be recorded separately from bar sales to the restaurant, on which tips would customarily be received by the dining room waitstaff.)

### How to allocate

There are two ways of allocating tips:

- **Good faith agreement** -- A written agreement between the employer and at least two-thirds of the tipped employees of each occupational category receiving tips. A good faith agreement becomes effective for the payroll period that begins after the date of adoption, but no later than January 1 of the next year. If tips are allocated according to a good faith agreement, a copy of that agreement must be attached to Form #8027.
- **IRS allocation formula** -- A worksheet describing two formula methods of allocation is attached to Form #8027
  - a. **Gross receipts formula** -- Employers with 25 or more full-time equivalent employees (i.e. 1,000 or more employee hours) per weekly pay period, including tipped and non-tipped employees, must use this “gross receipts attributable” formula if there is no good faith agreement in place.
  - b. **Hours worked formula** -- Only employers with fewer than 25 full-time equivalent employees (i.e. less than 1,000 employee hours) per weekly pay period may use this allocation method. Under this formula, the percentage of allocation is determined by dividing the total number of hours worked by all directly-tipped employees by the number of hours worked by each individual directly-tipped employee.

### Appeals

If the 8 percent allocation threshold is not reasonable for your operation because tipped employees are not *reporting* 8 percent of gross sales in tips (although they may be receiving more than they are reporting), you or your employees may petition the IRS for a reduction in the threshold for your operation.

The threshold may be reduced to as low as 2 percent upon written application setting forth sufficient information (such as charged tip rates, type of establishment, menu prices, hours of operation, type of clientele, location and amount of self-service) to support the argument that tips received by employees of the establishment are customarily below 8 percent. Refer to Form #8027 Instructions for complete information.

Appeals for reduced allocation thresholds should be filed as soon as possible before the Form #8027 filing due date (typically February 28 for paper filings) with: IRS - National Tip Reporting Compliance, 3251 North Evergreen Dr. NE, Grand Rapids, MI 49525.

Employees may petition the IRS themselves for a reduced allocation threshold if the petition is consented to by a majority (more than half) of the directly tipped employees of an establishment. These employees have the burden of supplying sufficient information to allow the IRS to estimate the tip rate of the establishment. However, the employer must provide relevant information to the IRS upon request of the employees or the IRS. The information will remain confidential.

### Employees must report tips/ Employers must allocate if covered

The IRS is increasing its efforts to detect tip reporting deficiencies. Undercover work and audits are yielding millions of dollars in new tax revenue for the federal

**Questions? Call the WRA Hotline: 1-800-589-3211**

Revised March 2012



## Guide to laws and regulations for restaurant owners

# TIPS AND TAXES (CONTINUED)

government. The courts have upheld IRS tip estimates and subsequent income tax bills to employees for unreported tips of up to 14 percent of gross sales at some establishments as a result of audits.

The most important thing for the employer to remember is that under-reporting tips by your employees may mean that you have to go through the hassle of allocation. You also may be charged a lump sum for several years worth of back FICA taxes due on unreported tips.

Let the employees know:

- The law requires them to report *all* of their tips.
- Employers must allocate tips up to 8 percent of gross sales, if reported tips do not reach that amount.
- The IRS may audit and bill them for taxes on estimated tip amounts greater than the 8 percent allocation -- plus penalties for underreporting.

### Employer FICA income tax credit.

As an employer in the food and beverage industry, you may be entitled to a credit for the social security and Medicare taxes you pay on your employees' tip income. This credit is available under Internal Revenue Code (IRC) section 45 B, "Credit For Portion Of Employer Social Security Paid With Respect To Employee Cash Tips." To file for the credit, use IRS Form #8846. You must meet both of the following requirements to qualify for the credit:

1. You had employees who received tips from customers for providing, delivering, or serving food or beverages for consumption; and

2. You paid or incurred employer social security and Medicare taxes on these tips.

The IRC section 45 B credit is available for taxes paid after December 31, 1993. You can claim or elect not to claim the credit anytime within three years from the due date of your return on either your original return or an amended return.

Since it is an income tax credit, claimed on an

income tax return, you may use it to offset any regular income tax liability, but not employment tax liabilities. A credit is a dollar for dollar reduction of your regular tax liability, where an expense deduction only reduces your taxable income. You and your accountant should evaluate, annually, whether the credit or the expense deduction is more beneficial to you.

The IRC 45B credit is not refundable which means if the credit reduces your regular income tax below zero, to a negative amount, the negative amount is not sent to you as a tax refund. However, it is subject to carry back and carry forward provisions of the IRC, as are other components of the business tax credit. Credits arising in tax years beginning after December 31, 1997 may be carried back one year and forward 20 years. Credits arising in tax years beginning before 1998 may be carried back three years and forward 15 years.

**Example:** An employee works 35 hours this week and reports \$200 in tips. The employee's base wage is \$2.33 per hour. *In 2007, the IRS froze the minimum wage rate at which the credit is computed at \$5.15 per hour. This will remain the same even when the minimum wage increases.*

Minimum wage =	\$5.15
Base wage =	- \$2.33
Tip credit =	<u>\$2.82</u>
Tip credit =	\$ 2.82
	x <u>35 hours</u>
	<u>\$98.70</u>
Tips reported =	\$200.00
Tips to satisfy min. wage =	- <u>\$ 98.70</u>
Tips eligible for tax credit =	\$101.30
Tips eligible for tax credit =	\$101.30
FICA tax rate	x <u>.0765</u>
Amount of tax credit	<u>\$7.75</u>
Potential annual savings per employee =	\$ 7.75
	x <u>52 weeks</u>
	<u>\$403.00</u>

**Questions? Call the WRA Hotline: 1-800-589-3211**

Revised March 2012



# Restaurant owners' frequently asked questions *TIPS AND TAXES*

**Q:** Our restaurant's bussers receive tip outs from the waitstaff. Do I have to keep track of this money?

**A:** Yes. All employees who receive more than \$20 per month in tips must report 100 percent of their tips and pay taxes on them. This includes bussers, bartenders and any other employees who hit that \$20 mark, even if they are being paid full minimum wage or more.

**Q:** How can I handle a server whom I strongly suspect is underreporting tips?

**A:** As an employer, your responsibility is only to inform your employees about their 100 percent tip reporting obligation and to file the required reports with the IRS. However, because you probably don't want to pay extra base wages to a server who doesn't report enough tips to allow you a full tip credit, and you don't want to hassle with allocating tips at tax time, you have good reason to be upset with obvious underreporting of tips.

If your waitress reports substantially poorer tips than her co-workers, you may tell her it must be a sign of bad customer service -- if her service and tips don't improve soon, you will have to let her go. Also, remind her that you could be audited and if auditors find her to be underreporting tips, she could pay stiff penalties.

**Q:** Our policy is to add a 15 percent gratuity onto the bills of large parties. Between the meal and drinks, the sales tax and the gratuity, how do I figure the bill?

**A:** Your 15 percent gratuity is a required payment -- therefore it is not a voluntary tip but a service charge in the eyes of the law. While tips go to servers, service charges go to the business and the restaurant must collect sales tax on the charge.

The proper way to calculate the bill is to add the cost of the meal and the drinks; then calculate and add the service charge; finally, figure the sales tax and add it to the total.

**Q:** Many of our customers leave tips on their credit cards. I don't receive the whole amount of the tip back from the credit card company because of their charges and I don't receive the money until weeks later. My servers expect to be paid the whole tip on that night. What do I have to do?

**A:** When tips are charged on credit cards, you are allowed to deduct from the tip the same percentage as the credit card company charges you. If you pay the credit card company a 2 percent discount rate, you can deduct 2 percent from the server's tip. Example: the customer charges a \$10 tip and you give the server \$9.80.

You do not have to pay your server the same night the tip is earned but, regardless of when you receive the money from the credit card company, you do have to pay your server by the next regular payday. WRA recommends charged tips be paid out through the regular payroll. This ensures that there will be enough money on the employee's check to cover taxes and other deductions.

**Questions? Call the WRA Hotline: 1-800-589-3211**

Revised March 2012