



# UNINVITING as an AUDIT

*An Update on Proper Tip Reporting  
and Tip Pooling*

BY DOUGLAS H. DUERR, ESQ.

The hospitality industry continues to face many challenges, especially in the current economy. Among those challenges continues to be the requirements to properly treat tips when compensating employees and to comply with tip reporting. These issues are still very critical tasks for restaurant and business owners. It has been estimated that on a national average, in full-service restaurants, servers earn 58 percent of their income through tips, while in so-called “counter-service” establishments, 61 percent of the servers’ earnings are tips. Proper reporting and treatment of tips benefit restaurant owners.

## TIPPING VALET SERVICE CAVEATS

In addition to considering tip pooling, employers that offer valet service must also consider the new change in tips law for valet services. Unbeknownst to the customer, both the restaurant and the valet service could have significant and potentially expensive legal obligations to the valet driver. Indeed, those same valet drivers are now increasingly filing complaints with government labor departments and in court to recover wages.

It is an almost universally accepted practice that valet drivers are treated by restaurants, or the valet companies to whom the restaurant has outsourced the service, as independent contractors. These individuals will then work for most of the tips received from patrons (or all tips less a “charge” for each car parked), and they may earn a significant income by doing so. While this may seem normal, as it was the industry standard for many years, restaurants and valet providers that use this structure likely are violating the Fair Labor Standards Act (FLSA).

No matter how valet companies structure their relationship with the parking attendants, such individuals usually are employees of the valet company, not independent contractors. If the parking attendants are deemed employees, not independent contractors, the FLSA requires payment of minimum wages and overtime. Restaurateurs should take heed of how the valet service pays its drivers, as there is a strong argument that you are joint-employers of the parking attendants with the contracted valet company and may be responsible for unpaid wages to the valets.

Plaintiffs’ attorneys are salivating over this unappetizing trend in states like Florida, Texas and Arizona. American Valet and Limousine Inc., located in Phoenix, paid about \$80,000 in penalties after the Labor Department accused the company of willful violations of both the minimum wage and overtime provisions of the FLSA. Five Star Valet Inc., which provides valet service to restaurants in Houston, agreed to pay current and former valet service workers to resolve violations of the overtime provisions of the FLSA. In December 2008, three valet companies were sued for unpaid wages in a Florida federal court because the valets were treated as independent contractors and did not receive all wages required by the FLSA. A similar lawsuit was filed against three different valet companies in the same federal court in January 2009.

This trend is moving toward other states; therefore, it is critical for valet companies and restaurants to make changes now to ensure parking attendants are paid in accordance with the FLSA, as the failure to do so can have burdensome and costly consequences. To avoid these issues, many valet companies are adopting a small parking fee for each car, which normally covers the valet company’s overhead and the wages. The valets should be allowed to retain all tips voluntarily paid by customers in addition to the established parking fee.

*While there is little you can do to prevent employees from entering into informal arrangements to split tips between them, do you want to have a formal or mandatory system for sharing tips?*

The hospitality industry continues to face many challenges, especially in the current economy. Among those challenges continues to be the requirements to properly treat tips when compensating employees and to comply with tip reporting. These issues are still very critical tasks for restaurant and business owners. It has been estimated that on a national average, in full-service restaurants, servers earn 58 percent of their income through tips, while in so-called “counter-service” establishments, 61 percent of the servers’ earnings are tips. Proper reporting and treatment of tips benefit restaurant owners.

## IRS REPORTING

To avoid or survive an Internal Revenue Service (IRS) audit, an employer in the hospitality industry must be certain to remember the following:

**Management is required to gather employees’ tip reports.** The IRS requires any employee who receives more than \$20 per month in tips to report those tips to his or her employer at least monthly.

**Management must report employees’ tips to the IRS and withhold taxes.** Employers are required to pay the employer’s share of payroll taxes on tips, plus withhold all the required income and FICA and other payroll taxes on wages and reported tips from wages actually paid the employee.

**Be aware of which form to file with the IRS.** Certain employers must file the IRS Form 8027 with the IRS — and, in some cases, “allocate” tips. *Tip allocation* is a process that alerts the IRS to restaurants that may not be reporting all of their tips. It requires restaurants to “allocate” tips to any directly tipped employee who reported tips of less than 8 percent of his or her sales. (For a copy of the form, visit [www.irs.gov/pub/irs-pdf/f8027.pdf](http://www.irs.gov/pub/irs-pdf/f8027.pdf).) For more information, see “Additional Sources” on Page 35).

Employers should educate employees on tip reporting. No business owner wants to manage employees' tip reports; however, if reporting is not done properly by the employees, a business is vulnerable to an IRS audit.

## TIP POOLING AND TIP CREDIT

Tip pooling must also be considered when reporting tips. It is common practice in many eating and drinking establishments to pool or split tips among employees. In some instances, the "tip pool" is simply a fish bowl. In other establishments, there is a more sophisticated system of collection and distribution with elaborate records and significant management involvement. While there is little you can do to prevent employees from entering into informal arrangements to split tips between them, do you want to have a formal or mandatory system for sharing tips? To answer this question, consider these issues:

**First, you need to understand tip credit basics.** Under federal law and in many states, employers are permitted to take a "tip credit" against the minimum wage for tipped workers. For example, under federal law, an employer may pay a tipped employee (an employee in a tipped occupation who customarily and regularly receives at least \$30 a month in tips) a cash wage of at least \$2.125 per hour, provided the employee earns enough in tips to bring hourly earnings to at least \$7.25 per hour.

In many states that permit the tip credit, the minimum cash wage is higher and/or an employee must earn more tips per hour to meet the state's minimum wage (e.g., Massachusetts requires a minimum cash wage of \$2.63 per hour and enough in tips to bring the wage up to \$8 per hour). While there are generally limitations and other requirements that must be met to take advantage of the tip credit, a key requirement is that the employee actually receive tips. While this is a straightforward matter when a customer directly hands an employee a tip for a particular service, in most instances,

customers typically leave undivided tips. That is, they leave a single amount for all of the services they received.

**Second, you should understand that at its simplest form, the tip pool is completely voluntary, with employees simply agreeing among each other who should receive how much.** Provided that the agreements are completely voluntary (i.e., neither required nor "encouraged" by management) with no management involvement in distributions, such arrangements generally do

not raise legal implications for the employer. Of course, as tips are "income" under federal and most state tax laws, employees must still be required to report tip income to the employer for payroll purposes (e.g., minimum wage and overtime compensation calculations, withholding and employment taxes) and to state and federal taxing authorities. However, even though the law generally does not interfere with such fully voluntary arrangements, to avoid any assertion an employer is taking some

## ADDITIONAL SOURCES

**Reporting Tip Income** – Restaurant Tax Tips (Including Tip Allocation)  
[www.irs.gov/businesses/small/industries/article/0,,id=98401,00.html](http://www.irs.gov/businesses/small/industries/article/0,,id=98401,00.html)

**Audio: What Every Operator Should Know About Tip Pooling**  
(RestaurantOwner.com members)  
[www.restaurantowner.com/members/557.cfm](http://www.restaurantowner.com/members/557.cfm)

**Tip Reporting 101**  
(RestaurantOwner.com members)  
[www.restaurantowner.com/members/246.cfm](http://www.restaurantowner.com/members/246.cfm)

**America's Coast To Coast  
Network Of Regional  
Food Service Industry  
Websites**

Atlanta • Boston • Chicago • Dallas • Denver • Houston • Detroit • Las Vegas • Los Angeles • Miami  
Minneapolis • New York • Philadelphia • Phoenix • San Francisco • Seattle • St. Louis • Washington

Log onto [www.totalfood.com](http://www.totalfood.com) and click the region link  
to visit one of our 18 city regional sites.

203.661.9090 • [tfs@totalfood.com](mailto:tfs@totalfood.com) • [www.totalfood.com](http://www.totalfood.com)

“kickback” on tips, it is advisable to adopt a rule prohibiting managers and supervisors from participating in, or receiving, tips through even voluntary arrangements. Such a rule would be even more important in states that only permit voluntary tip pooling arrangements.

**Finally, you need to evaluate the pros and cons of “facilitated” and “required” pooling.** In many cases, employers either facilitate or require tip-sharing arrangements. There are a number of reasons why an employer may favor a mandatory or facilitated tip pool. Such reasons can include:

- ✓ A belief that a tip pool creates friendlier and better service as employees work together, thus enhancing repeat business from customers.
- ✓ Distributing tips to more employees will help management take full advantage of the tip credit for more employees, thus reducing labor costs.
- ✓ Redistributing tips to lower-tier employees results in less employee turnover, and management may be able to promote from within (e.g., bus staff to wait staff).

## CALIFORNIA COURT OF APPEALS DECISIONS ALLOW TIPS FOR EMPLOYEES WHO INDIRECTLY SERVE THE GUEST

In California, the court has extended tip pooling to include employees who do not provide direct table service, but who participate in the “chain of service” and contribute to the quality of the product/service provided with their labor.

Contrary to the California Department of Labor Standards Enforcement’s (DLSE) position that kitchen staff cannot be included in tip pooling, the California appeals court has issued rulings that take a more liberal position on the types of employees who may be included in the pool. In *Etheridge v. Reins International California Inc.*, the defendant employer had a mandatory tip pooling policy that allowed kitchen staff and dishwashers to participate in the tip pool. The servers filed suit claiming these employees could not receive pooled tips because they did not provide “direct table service.” The court, however, found as long as all participating employees can be considered as serving the customer, even in an indirect manner, then inclusion in a tip pool is not illegal.

In another case, *Budrow v. Dave & Buster’s of California Inc.*, the California court of appeals overruled the DLSE position, granting summary judgment to the restaurant defendant, citing the plaintiff argument that California limited pooling programs to only those providing direct service to the customer was based on a vague ruling that did not adequately define what constitutes “direct” versus “indirect” service.

✓ One court has suggested that management might put in place tip pooling simply to flex managerial muscle.

Besides the legal concerns, there are reasons why management may decide not to adopt or facilitate a tip pool. Those reasons can include:

- ✓ Tip pooling might discourage competition among wait staff to compete against each other. Competition can result in better service and more efficient turn of tables.
- ✓ Without tip pooling, less productive staff will be inclined to leave due to poor income, instead of being able to ride off someone else, while successful wait staff will stay.
- ✓ Tip pooling might be viewed as a waste of management resources, requiring the administering of yet another system.
- ✓ There has been no tip pool in the past, and among the staff who have been employed for a while, there is the feeling that their tips belong to them.

## IF YOU FACILITATE OR REQUIRE A TIP POOL, YOU NEED TO KNOW THE LAW

If you decide that a mandatory or facilitated tip pool arrangement fits within, or even advances, the business model then it will be necessary to comply with both federal and state law. Under federal law, mandatory tip pools are permitted; however, if an employer is taking advantage of the tip credit, tips can only be redistributed to other employees who work in an occupation that customarily and regularly receives tips. According to the regulations, such would, for example, include other servers, bartenders, service bartenders, counter personnel and bus persons.

There is case law expanding this list to the maitre d’ and host positions as well. Cooks and dishwashers are listed in the regulations as not being “tipped” employees. While this list is certainly not exhaustive of all the positions in a restaurant (e.g., dish polisher, sommelier, expeditor), basically a “tipped” position is limited to those with significant guest interaction, i.e., front-of-the-house positions. Managers and supervisors may not participate in a tip pool.

For a mandatory tip pool under federal law when taking advantage of the tip credit, the regulations seek to limit the amount of tips an employee must be required to contribute to the pool. The Department of Labor Wage and Hour Division, which enforces federal wage and hour law, will not challenge a requirement that employees contribute up to 15 percent of their tips to a tip pool (after taking into account any tips returned to the employee). Although this position has not been uniformly adopted by the courts, whatever formula is used to determine how much an employee must contribute to the pool should take this limitation into account. Of course, regardless of the contribution and distribution formulas, to avoid a minimum wage violation, an employee must end up with enough in tips to cover any amount taken as a tip credit by the employer.

## STATE ISSUES

Compliance with federal law on tip pooling does not mean that the restaurant complies with state law. In Kentucky, for

example, while voluntary tip pools are permissible and an employer may provide an employee with information about the voluntary pool, mandatory pools are not permitted.

Even in states that permit mandatory pools, however, there may be additional limitations. For example, in July 2004, Massachusetts passed "An Act Protecting the Wages and Tips of Certain Employees," which permitted mandatory tip pooling. Until passage of the act, mandatory tip pooling had been largely considered illegal in the state. Now tip pooling is permitted only for wait staff, service staff (certain employees not employed in the food and beverage industry) and service bartenders. To qualify as a "wait staff" employee, a worker must meet all of the three following criteria: the person must work in a

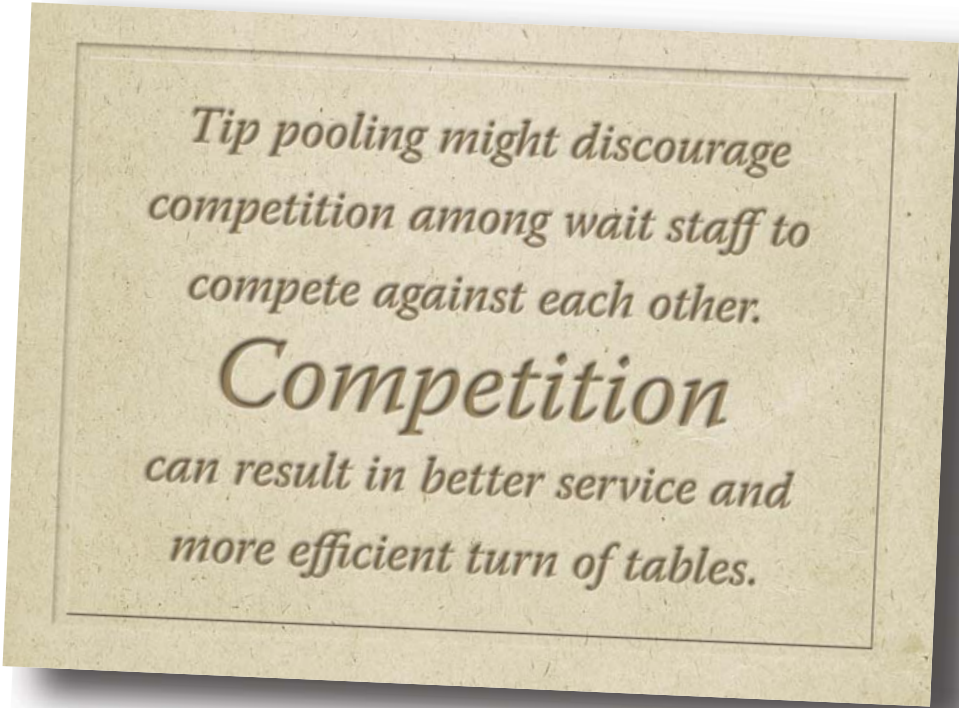
restaurant, banquet facility, or other place where prepared food or beverages are served; he or she must provide service to customers by serving beverages or prepared food directly, or by clearing customers' tables; and the worker may not have any managerial responsibility. Because of the requirement for "direct service" or table-clearing activities, this would tend to exclude a maitre d', host, etc., whom a restaurant could include in a mandatory tip pool under federal law.

In California, the court has extended tip pooling to include employees who do not provide direct table service, but who participate in the "chain of service" and contribute to the quality of the product/service provided with their labor. (See "California Court of Appeals Decisions Allow Tips for Employees Who Indirectly Serve the Guest" on Page 36.)

## RECORDS MATTERS

As with all matters involving money, it is imperative that the restaurant maintain exact records of what was reported in tips, what was paid into the pool and, finally, what was paid out and to whom. These records will not only aid in responding to claims against the restaurant, its managers and owners, but also aid in compliance with minimum wage laws and tax compliance. In the end, tip pools (like so many things) have their benefits and costs. The current federal minimum wage is \$7.25 per hour, although some states and localities have a higher minimum wage; employers must pay the higher rates. Federal law allows employers to take a credit for the tips received by "tipped employees" (at least \$30 per month, either directly or through a pool); provided, however, that the employer pays a cash wage of at least \$2.13 (again, some states require a higher cash wage or prohibit the tip credit entirely) and the employee receives enough in tips to make \$7.25 per hour.

To take advantage of the credit under federal law, however, certain circumstances must be met. One, the employees must



*Tip pooling might discourage competition among wait staff to compete against each other.*

**Competition**

*can result in better service and more efficient turn of tables.*

be given a notice that tip credit is being taken and the provisions of the law permitting the credit and, two, the employees must be able to receive their tips free and clear (although federal law and some states do permit pooling in certain circumstances). A common problem for employers taking advantage of the tip credit is calculation of the overtime compensation due. Employees are entitled to 1.5 times their "regular rate" for each hour of work over 40 in a week (or after eight hours per day in some states or localities). A tipped employee's "regular rate" is the amount of cash wages plus the amount of "tip credit" taken by the employer. Under federal law, if an employer pays the smallest cash wage (rounded to \$2.13) and takes the maximum tip credit (rounded to \$5.12), the regular rate is \$7.25 (the federal minimum wage). Therefore the minimum cash overtime compensation due is  $(1.5 \times \$7.25) - \$5.12 = \$5.76$  per hour.

## KEEP UP WITH THE CHANGES

Tip reporting is a crucial element to the restaurant industry and informing employees of the importance of providing accurate records. Tax laws change frequently; therefore, regularly checking for updates on tip reporting is crucial. Restaurant owners should consider adding tax reporting to their employee training schedule and frequently educating tipped employees on their responsibility to report all their tips. Proactively avoiding tip reporting pitfalls will help avoid an audit or other IRS problems in the future.

*Please note: Legal articles in this magazine are for your general information only. Legal advice must be tailored to the circumstances of each case, and laws constantly change. Federal laws, the laws of each state, and often each municipality vary, and each may have its own procedures and time limitations that must be followed. Confer with a lawyer in your state to assess your legal rights.*

**RS&G**