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HOSPITALITY
ALERT

SAY GOODBYE TO AUTOMATIC GRATUITIES

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On June 20, 2012, the Internal Revenue Service (IRS) issued Revenue Ruling 2012-18 to clarify and update existing guidelines on taxation issues affecting the hospitality industry. In particular, the ruling helped clarify the distinction between tips and service charges:

According to a previous ruling promulgated by the IRS (Rev. Rul. 59-252) and further clarified in Rev. Rul. 2012-18, a tip is narrowly defined as: (i) an amount of money presented by a guest free from compulsion; (ii) a payment that the customer has the unrestricted right to determine the amount of; (iii) a payment whose amount cannot be the subject of negotiation or dictated by employer policy; and (iv) generally, a payment in which the customer can dictate and determine the recipient. If these four factors are absent, under Rev. Rul. 59-252, the automatic or non-discretionary charge is not a tip and if any portion of the charge is distributed to an employee, it is considered wages for FICA tax purposes. The same factors must be examined with respect to automatic gratuities that are assessed for large parties at a restaurant.

This policy presents a myriad of problems to operators in the hospitality industry, and in particular to companies that are in the business of hosting banquets, private or similar events because it has long been industry practice for these types of businesses to add a mandatory "gratuity" or service charge to their banquet contracts or invoices.

First let us think about how this affects a company from a tax and reporting perspective. Since 1994, many restaurants have benefited from being allowed to apply a general business credit toward a portion of the employer's Social Security and Medicare taxes paid with respect to their employees' cash tip earnings (IRC 45 B). However, the policy set forth in Rev. Rule 2012-18 means that the credit would not apply with respect to service charges, because the mandatory charges do not qualify as tips. In addition, the restaurant should not be reporting the service charges paid out to the employees as tips on their payroll reports, but rather as wages. This also means that while completing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, the service charges distributed to the employees (assuming it is more than 10 percent of the sale) and the respective sale should not be included on the form. Last, for income tax purposes, the Gross Receipts from the event would include the service charge as income and the service charge paid out to the employee would then be reported as Salaries and Wages on the business tax return. All of the above differs from the treatment that would have applied if the charge was considered a tip.

Now, while the IRS does not have authority to issue regulations to or interpretations of the Fair Labor Standards Act (FLSA), the ruling does implicate some important issues concerning the federal minimum wage and overtime laws. Specifically, can an employer apply the tip credit to an employee's wages if he or she is working a shift where an automatic gratuity or service charge has been added to a guest's bill? The answer is relatively simple if an employee works a "banquet shift" or at a restaurant where the employer's policy is to charge a mandatory gratuity or automatic service charge to all patrons. In this scenario, the employer may not take

advantage of the tip credit for the simple reason that the employees are not earning any gratuities, as defined by the IRS and the regulations to the FLSA. In this scenario, the employee must be paid the regular minimum wage (currently the federal minimum wage is $7.25 per hour – but certain jurisdictions have implemented higher minimum wage rates) for the time spent working the banquet or private event. Because the mandatory service charges are not considered to be tips under federal law, employers within jurisdictions that adopt the FLSA in its entirety could conceivably keep the proceeds of the mandatory gratuity or service charge, or pay it out to the employees who worked the events as wages, bonuses or commissions.

Another issue to consider is that an employer who pays out a portion of the mandatory gratuities or service charges to employees may have to recalculate its employees' overtime rates (if the employees work more than 40 hours in a week). Because the regulations consider these payouts to be wages rather than tips, that money would count toward an employee's regular rate of pay and therefore must be factored into the overtime rate calculation.

Further complicating the mix is the fact that certain jurisdictions, such as New York State, define tips differently than the IRS or the FLSA – making the determination of the appropriate rate to pay employees extremely difficult and fact-specific.

The situation becomes much more problematic when an employee is serving a large party with an automatic service charge added onto the bill and simultaneously serving several smaller parties with no service charges all in the same shift. Because it is unclear under the current regulations whether an employee working under this "hybrid" scenario would be considered to be engaging in a "customarily and regularly tipped occupation," employers in this situation are facing an administrative nightmare that could expose the company to Department of Labor audits (and collective action lawsuits) if not treated or calculated correctly. Accordingly, we strongly recommend that employers micromanage their schedules to avoid having an employee simultaneously provide service to guests who are leaving totally voluntary tips and to other guests who are paying mandatory gratuities or service charges.

As if this isn't complicated enough, here is more fuel for the fire.

On February 23, 2012, New York State issued Bulletin No. TB-ST-320 to explain how state and local sales tax applies to gratuities and service charges. (Please note that New Jersey and Connecticut have very similar laws when compared to New York). Voluntary gratuities left by a customer are not taxable. Mandatory gratuities are those that are automatically added onto the bill or provided for by contract. Mandatory gratuities or service charges are taxable, unless:

- The charge is shown separately on the bill
- The charge is specifically designated as a gratuity or tip
- The business gives the entire amount of the separately stated gratuity to its employees

When we apply the federal rules and compare them to New York State's, an interesting result occurs. Service charges on banquets and automatic gratuities on large parties that are paid out to employees are considered wages (and not gratuities) for FICA tax purposes, but New York State considers them gratuities for sales tax purposes if the assessment is specifically listed as a gratuity on the bill or invoice and the entire amount is given to the employees.

Now let's throw something else into the mix. When customers pay by credit card, many restaurants reduce the tips paid to employees by the administrative fee charged by the credit card companies. If the gratuity is voluntary, it is considered a tip for FICA tax purposes and is not subject to New York State Sales Tax, so the requirement to meet the above three conditions is not applicable. However, what happens when a mandatory gratuity or automatic gratuity is charged on a credit card and the restaurant reduces the gratuity by the administrative fee charged by the credit card companies? Arguably, the mandatory or automatic gratuity, along with the rest of the bill, would be subject to New York Sales Tax (even if it is called a gratuity) because, based on the literal reading of the third bullet above, the entire amount is not given to the employee.

By way of example of some of the issues discussed above, assume: a server in New York State works a six-hour shift. The server has served a total of eight tables; two large parties with an automatic gratuity of 18 percent totaling $200 included on the bill and six smaller tables with voluntary gratuities totaling $120. The employee has spent three hours at the two parties with the automatic gratuity, and three hours at the six smaller tables.

Consider whether:

- The employer could use the $200 as a credit against its income tax
- The employer could apply the tip credit toward the

wages owed to the employee who served these eight tables

- The $200 counts as gross income to the employer
- The $200 is subject to sales tax
- You could require employees to pool the $200 received from the guests subject to the automatic gratuity, if under federal law that amount is not considered a tip

Unfortunately, the answers to these questions are very fact-specific and depend on a multitude of factors, including how the charge is presented to guests, whether the automatic gratuity was left in cash or credit card, whether the employer deducts the credit card processing fees from the charge and the amount of time the employee spent on each type of guest.

Are you ready to eliminate automatic gratuities or service charges? The good news is that even though the Revenue Ruling is effective immediately and applicable retroactively, depending on the facts and circumstances, this Revenue Ruling could be applied prospectively with regard to amounts paid before January 1, 2013.

What is the solution? There are a few options and restaurant owners may not like any of them. Here are some suggestions:

- Indicate a "suggested gratuity" on the customer's receipt but do not add it to the total on the receipt allowing the customer to designate the gratuity voluntarily
- Charge sales tax on all service charges, regardless of the amount paid to the employee
- Eliminate all service charges and automatic gratuities
- Consult with your tax advisor or attorney to determine the proper method of taxing service charges and paying your employees

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