Consequences of New IRS Revenue Ruling Concerning Tax Treatment of Automatic Gratuities

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Introduction

Many restaurants automatically add a predetermined gratuity to the bills of banquets and other large group meals as a way to assure that their service staffs are compensated fairly for their service. Typically, restaurants have treated such auto-gratuities as tips, subject to all of the normal payment, reporting and payroll withholding rules established over the years by the IRS for the tax treatment of tips. However, in the summer of 2012, the IRS released Revenue Ruling 2012-18, which reiterated and reemphasized its rules for the tax treatment of auto-gratuities. In that announcement, the IRS stated that it would, in the future, as it had in the past, treat auto-gratuities, not as tips, but as service charges, which are treated very differently for payroll tax purposes. The revenue ruling became effective January 1, 2014.

Although similar rulings had been issued by the IRS in the past, the IRS admitted in Rev. Rul. 2012-18 that it had been more focused in recent years on trying to assure compliance by tipped employees and their employers with their gratuity income reporting obligations, and, as a result, had been less worried about whether those gratuities had been properly classified as service charges or tips. The IRS announced in no uncertain terms in Rev. Rul. 2012-18 that, moving forward, it intended to pay closer attention to the proper classification of gratuities. In order to give restaurant owners time to change their programs to conform to the new enforcement initiative, the IRS initially announced it would not begin enforcement until January 1, 2013. In response to public comments indicating that restaurants needed more time to adapt, on December 27, 2012, the IRS extended the effective date of the changes to January 1, 2014.

With the start of 2014, restaurant owners are now expected to be in compliance with the revenue ruling, which presents a number of very difficult challenges for restaurants. Employers are understandably concerned that enforcement of the rule will ultimately reduce the take-home pay of their waiters, bartenders and anyone else dependant upon tip income. The ruling also raises a number of questions that, depending upon how they are answered in the future, could make life for restaurant owners even more difficult than it already is.

Taxation of Tips

Taxation of tips is governed by §3121 (a) and (q) of the Internal Revenue Code. Unless the restaurant has some type of tip pooling policy in place, typically, employees keep whatever cash tips they receive on any given shift. Credit and debit card tips are generally paid to employees on some established regular schedule, say at the end of each week or pay period. Employers are not required to withhold payroll taxes from their employees' tips. However, tips are considered wages for FICA tax purposes and, therefore, are required

under Internal Revenue Code §6053 to be reported to the employer by any employee who receives at least $20 in any month in any combination of cash, credit card or debit card tips. The employee must report all tip income to the employer on Form 4070 by the 10th day after the end of each month. The employer is obligated to collect the employee's portion of payroll withholding taxes (FICA and Medicare) owed each month from each of its tipped employees. Employers can collect tip information from their employees on any schedule they want, but it is the restaurant's responsibility to report, collect and pay over to the government its employees' withholding taxes accurately. Employers must also pay their portion of FICA taxes on their employees' tips, subject to certain credits that will be discussed later in this paper.

Taxation of Service Charges

Service charges are also considered to be income by the IRS, but, by contrast to the rules for tips, the restaurant, not the employee, is obligated to report the service charge income paid to its employees. Also, unlike with tips, the employer must withhold payroll taxes *before* paying any service charges to its employees. If a payment to an employee is considered a tip, therefore, no withholding is required before payment to the employee, but, if the payment is considered a service charge, then the restaurant must withhold payroll taxes before paying it to the employee.

Factors The IRS Uses To Determine Whether A Payment Is A Tip Or A Service Charge.

The employer's classification of a payment as either a tip or service charge is not determinative. The IRS has announced that it will look at a number of factors in deciding whether a particular payment is a tip or service charge. To be considered a tip:

- The payment must be free from compulsion;
- The customer must have the unrestricted right to determine the amount;
- The payment must not be the subject of negotiation or dictated by restaurant policy; and
- The customer must have the right to decide who receives the payment.

Using those criteria, a restaurant that automatically adds a charge of 18% to all bills for groups of 8 or more – the typical auto-gratuity – would be receiving a service charge, because the payment was not free from compulsion and was dictated by restaurant policy. By contrast, a restaurant that suggests on its bills for large groups the payment of a gratuity of 18%, and includes a calculation of the amount of such a tip, but leaves the decision whether to tip and the amount to the customer, would be receiving a tip, because such a payment satisfies all 4 criteria used by the IRS to make such determinations.

Changes Caused By REV. RUL. 2012-18

The revenue ruling announcing the IRS' intention to enforce the reporting and withholding rules regarding service charges raises a number of questions and quite a few complications for restaurants.

Are Auto-Gratuities Subject To The FICA Tip Credit?

Answer: No.

Unlike tips, service charges are not eligible for the §840B FICA Tip Credit for FICA tax obligations paid by employers on tips in excess of those treated as wages for purposes of satisfying the minimum wage requirements. In New Jersey, the minimum wage, as of January 1, 2014, is $8.25, except for "tipped employees", for whom the minimum wage is $2.13, the same rate for tipped employees mandated by federal law.[1] The difference between the two numbers, or $6.12/hour, must be received by the employee either in the form of tips or as additional salary paid by the employer. Thus, if a waitress does not receive enough tips during her pay period to bring her wages up to at least $8.25/hour, the restaurant must make up the difference by payment of additional salary. Conversely, when tips paid to the employee exceed the minimum wage amount, the employer is entitled to a FICA Tip Credit for FICA taxes paid by the employer on the tips in excess of the minimum wage amount. The employer may not claim the credit if the payment to the employee is a service charge, because the service charge payment is considered to be part of ordinary wages, which are always subject to the payment of payroll taxes up to the wage base, which, for 2014, is $117,000. This change in tax treatment could result in higher payroll tax obligations for restaurant employers.

However, because service charges can be claimed by a restaurant as a deduction, with proper planning, a restaurant that pays its servers both service charge and tip income during a given pay period, might be able to actually reduce its tax obligation.

Do Auto-Gratuities Raise The Employee's Hourly Pay Rate For Purposes of Computing Overtime Pay?

Answer: Most likely.

Although there is a disagreement among commentators on this point, and there has been no definitive ruling as yet, because they are considered service charges, which are treated as regular wages, auto-gratuities, unlike tips, most likely must be factored in when calculating an employee's salary for purposes of computing overtime pay. As a hypothetical, suppose a waiter, paid at the minimum wage rate of $2.13, works 45 hours during a week, collects $315 in tips and also works a banquet, for which he is entitled to receive a $40 auto-gratuity that week. The waiter's **salary** for his 45 hours that week would be $95.85 ($2.13 x 45 hours), plus the $40 service charge, for a total of $135.85. Adding his tips to that total brings his total **income** for the week to $410.85 ($95.85 + $40 + $315), which is more than the minimum wage of $371.25 ($8.25 x 45 hours), so his employer need not pay him additional salary to bring his rate up to the minimum wage. However, calculation of his pay rate for purposes of computing overtime is more complicated. His base hourly rate of pay for *that week* for his 40 hours of regular time would actually be $3.13 ($2.13 x 40 hours = $85.20; $85.20 + $40 = $125.20: $125.20 ÷ 40 hours = $3.13). That is the rate the employer must use to calculate the employee's overtime pay, which is $7.83 (½ x 5 hours x $3.13). In calculating overtime pay, therefore, treating the auto-gratuity as a service charge has the possible effect of increasing the waiter's take home pay.

Under the above scenario, the employer would be required to withhold payroll taxes from the sum of $143.67 ($95.85 regular wages + $40 service charge + $7.83 of overtime pay), and the employee would be obligated to report and pay payroll taxes on the $315 of tips by no later than the 10th day of the following month.

Under the assumption that service charges must be factored in when calculating overtime pay, employees' rates of pay will vary from week to week, according to the amount of auto-gratuities they receive each week, which will require restaurants to be sure that their payroll provider has adjusted its software to calculate the fluctuating weekly pay rate accurately.

Will Treating Auto-Gratuities as Service Charges Have An Impact On Other Employee Benefits?

Answer: Most likely.

Again, there has been no definitive ruling on this point, but, using the same analysis applied to the overtime question, any employee benefit (e.g., payment of unused vacation time, retirement plan payments, etc.) that is calculated based upon wages could also be impacted by the IRS ruling, because employees' base wages will fluctuate over the course of a year depending upon the amount of gratuities that are treated as service charges.

How Will The New Rule Affect Restaurants' Sales Tax Obligations?

Answer: It depends.

Under New Jersey law, tips paid to servers are not subject to sales tax. What about service charges? In the wake of Rev. Rul. 2012-18, New York, which has sales tax laws similar to New Jersey's, issued a Bulletin No. TB-St-320 in February of 2012, which was intended to explain how state and local sales taxes applied to gratuities and service charges. About a year later in March of 2013, the New Jersey Division of Taxation revised its Bulletin S&U-1, which addresses sales taxes and restaurants. Both the New York and New Jersey bulletins clarified that voluntary gratuities are not subject to sales tax. By contrast, mandatory gratuities, such as auto-gratuities, are subject to sales tax unless 3 factors are present:

- 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. Thus, the same auto-gratuity could be treated as a tip for sales tax purposes but as a service charge for payroll tax purposes.

Does The Answer To The Sales Tax Question Change If The Patron Pays The Bill With A Credit Card?

Answer: Possibly, if the restaurant deducts the service charge from the amount it pays to its employees.

Payment of the bill containing an auto-gratuity by credit or debit card could make the gratuity subject to sales tax, if the employer keeps a portion of the amount for itself to cover the service fee charged by the bank for processing credit card payments. Suppose the patron in the above example pays the bill that includes the auto-gratuity with a credit card and further assume that the restaurant has a policy that tips paid to employees are reduced by the amount of the processing fee charged by the credit card company. Does this new fact make the auto-gratuity subject to sales tax? Although there have been no cases reported yet, under the criteria set forth in the New Jersey and New York Bulletins, the gratuity would, most likely, be

subject to sales taxation because it would fail the third test, in that the restaurant is not paying the entire amount of the gratuity to its employees. This likely result has prompted some commentators to suggest that restaurants should add sales tax to all auto-gratuities, or at least those paid by credit cards. However, restaurant owners might very well be concerned that such a policy could alienate customers who are, perhaps, already unhappy about being charged an auto-gratuity.

What Impact Will The New Ruling Have On Tip Pooling Policies?

Answer: The new rule might make it impossible for restaurants to force employees to pool auto-gratuities under some circumstances.

Many restaurants have policies that require the pooling of some or all tips. Such policies are especially popular for distributing gratuities from large events and banquets, for which there are several servers. Now that the IRS has clarified that auto-gratuities are not tips for payroll tax purposes, can restaurants require their employees to pool auto-gratuities? A service charge, by definition, unlike a tip, is the property of the restaurant to do with as it pleases.[2] However, a policy requiring pooling of service charges might also be challenged under the state's wage and hour laws, for example, by a server who worked a banquet, who could argue that he was forced to share his *regular wages* with an employee who did not work the banquet. There have been no such challenges reported to date.

There could also be unintended consequences of such a change in policy. For example, will the pooling of an auto-gratuity make it subject to sales tax? Arguably, at least, the pooling of an auto-gratuity would defeat the customer's ability to decide who receives the payment, one of the criteria used in both New Jersey and New York to determine whether a gratuity is a tip and thus not subject to sales tax. Questions like this have not yet been answered. In addition, the pooling of auto-gratuity service charges will also most likely impact all affected employees' hourly wages for any pay period in which an auto-gratuity is pooled, thereby further complicating the restaurant's payroll and opening the door for more potential payroll errors and future wage and hour claims. Whatever a restaurant decides to do regarding payment of auto-gratuities to its employees, it should pay them through its regular payroll service to avoid liability for unpaid payroll taxes owed on the auto-gratuities, which, as noted above, must be withheld from an employees pay before payment to the employee.

Although these issues have not yet been resolved by the various taxing authorities, it is clear that the new revenue ruling will complicate life for restaurants with tip pooling policies.

Additional Issues

Because the IRS has just implemented the revenue ruling regarding auto-gratuities, there is no guidance yet as to how it will administer the ruling in the real world of everyday restaurant operations. Consider the following hypothetical situation and the numerous unanswered questions it raises.

Assume a server worked lunch and dinner for a 10 hour day and served 12 tables during that time: 4 large parties with an auto-gratuity of 20%, amounting to $50 each, and totaling $200, and 8 smaller parties with tips totaling $150. Two of the large parties paid by credit card, and the other two paid cash. The server spent 6 hours at the 4 large tables and 4 hours at the 8 smaller tables. Here are some questions raised by this scenario:

- Can the restaurant claim a tip credit for the $200 against its income tax obligation?
- Can the employer apply the full $350 tip credit toward the wages owed to the server or is it limited to the $150 tip amount?
- Is the $200 auto-gratuity counted as gross income to the restaurant?
- Is the full $200 subject to sales tax?
- Is the full $200 in service charges subject to sales tax, or, alternatively, is the $100 amount paid by credit card?
- If the employer has a tip pooling policy, can it require the server to pool the $200 of auto-gratuities? If it does require pooling, does that policy subject the entire $200 to sales taxation?
- How is the server's overtime pay for that day calculated, and do the hours worked per table get factored into the calculation?

The answers to these questions depend upon a number of factors, including whether the auto-gratuities are mandatory or suggested, how much time the server spent with each table and whether the various bills were paid by credit card or cash. Some of the answers will also depend upon whether the restaurant deducts the credit card service fees from the amount paid to the server.

Possible Solutions To Consider

It is clear that the recent revenue ruling adds multiple layers of complication and potential land mines to restaurant owners' already complex operations. In response to this ruling, several restaurants, such as the Darden Group, which owns such national chains as Capital Grill, Olive Garden and Red Lobster, has already announced that it is abandoning its auto-gratuity policies. Many others will follow, deciding that their auto-gratuity polices are just not worth the headaches caused and risks posed by this new ruling. If not handled sensitively, such restaurants run the risk of angering their staffs, who might fear that these decisions could result in lower total gratuities from their large tables.

What can a restaurant do to ameliorate the negative impact on the morale of its staff that might be caused by a decision to abandon auto-gratuities? A restaurant might want to consider a program to educate all of its patrons, not just large parties, about the protocols and etiquette of tipping. A restaurant could, for example, consider adding a note to every bill that says something like:

Our servers have been trained to provide excellent service to you. Please tell us if you are unhappy with any aspect of the service you received today. The minimum wage for restaurant servers is much lower than for other workers, because it is assumed that you and all of our patrons will reward your server with a tip that reflects the level of service you have received. The following are guidelines for you to consider using:

- Excellent service (20%) _____ (or more)
- Good service (18%) _____
- Adequate service (15%) _____
- Your Tip Amount: _____

[NOTE: The restaurant's computers could be programmed to calculate and print on the bill the exact amounts of each percentage for that particular bill.]

There are endless variations to this message that could be added to a bill. Or, the message could be placed on a small placard on each table. Restaurants considering eliminating their existing mandatory gratuity policies in the face of the new revenue ruling, should consider replacing them with a voluntary program that includes a component to educate patrons about the importance of tipping in general.

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[1] President Obama recently announced his intention to seek an increase of the federal minimum wage to $10.25.

[2] Query whether a customer charged an auto-gratuity on a bill under the guise that it is intended to compensate the servers for their service might have a breach of contract or fraud case against the restaurant that decides, instead, to keep the service charge and not distribute it to employees. Of course, that restaurant might have trouble keeping its employees for long with such a policy.