

By Brian Roth

THE TIPPING POINT:

Does a Recent IRS Ruling Mean the End of Automatic Gratuities?

Many restaurants have a policy of adding an automatic gratuity of 15 to 20 percent to bills of large parties and banquets. The idea is to make sure restaurant employees are adequately compensated for their work, on the theory that patrons are less likely to leave a 20 percent tip on a large bill than a small one. After an IRS ruling effective January 1, 2014, however, restaurants may want to reconsider the use of automatic gratuities.

Revenue Ruling 2012-18 classifies automatic gratuities as service charges, which are considered restaurant income.¹ If these service charges are distributed to employees, they are considered wages, not tips. This disrupts the long-standing restaurant industry practice of treating automatic gratuities as tips.

In its ruling, the IRS clarified that an employer's characterization of a payment as a "tip" is not determinative.

Rather, four factors are considered to determine whether a payment is a tip or service charge.

1. The payment must be made free from compulsion;
2. The customer must have the unrestricted right to determine the amount;
3. The payment should not be the subject of negotiation or dictated by employer policy; and
4. Generally, the customer has the right to determine who receives the payment.

The IRS concluded that the absence of any of the four factors creates a doubt about whether a payment is a tip and not a service charge. Automatic gratuities – which fail to meet any of the criteria above – are clearly service charges.

Service charges belong to the restaurant and are considered part of its gross receipts. Additionally, they are considered income to the restaurant. Service charges can be retained exclusively by management or distributed to employees in any amount.

Why it matters

Inability to take the "tip credit" in some situations. Perhaps the biggest change wrought by the IRS's ruling is that restaurants that impose automatic gratuities

1. Rev. Rul. 2012-18, 2012-26 I.R.B. 1032.

Many restaurants impose a set gratuity on large groups to make sure servers get their fair share. But as of January 1, the IRS classifies automatic gratuities as service charges, which are considered wages and not tips. Find out what the change means for your employer clients.

can no longer take the “tip credit” – permitted by the Fair Labor Standards Act (FLSA) for employees who customarily and regularly receive tips – even if they distribute the gratuities to employees.²

That means these restaurants must pay employees who serve these large parties and banquets at least the applicable minimum wage, because the employees are technically performing non-tipped work. This includes bussers and other front-of-the-house employees who are lawfully involved in tip pools.

Difficulty in determining wages for employees who have dual duties. Where employees have dual duties – e.g., they simultaneously serve smaller parties that are not subject to a service charge and large groups that are – restaurants face the daunting task of determining what wages to pay employees, who are performing tipped and non-tipped work. The FLSA tip credit can be taken for only tipped work, but it seems impossible to separate tipped from non-tipped work when the tasks are performed concurrently.

Recalculation of overtime rates. A related issue is that restaurants need to recalculate employees’ overtime rates when they are paid a portion of automatic gratuities and work more than 40 hours in a week. Because the IRS’s ruling classifies automatic gratuities as wages and not tips, those payments count toward employees’ regular rates of pay. Consequently, they must be factored into employees’ overtime rates.

Payroll and tax implications. The IRS’s ruling presents numerous tax implications. First, the Federal Insurance Contributions Act (FICA) tip credit, permitted toward a portion of restaurants’ Social Security and Medicare taxes paid with respect to employees’ cash tip earnings,

no longer applies to service charges.³ Thus, the IRS’s ruling likely lowers the amount of the FICA tip credit available to restaurants.

Second, restaurants should report service charges distributed to their employ-

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ees as wages, not tips, on their payroll reports. Likewise, restaurants should omit service charges distributed to employees (assuming they exceed 10 percent of the sale) and respective sales when completing Form 8027 (Employer’s Annual Information Return of Tip Income and Allocated Tips).

Third, for income tax purposes, an event’s gross receipts include the service charge as income, and any amount of the service charge distributed to employees should be reported as salaries and wages on the business tax return.

Solutions

Eliminate automatic gratuities, but provide suggested tip amounts. The most straightforward way to avoid the effects of the IRS’s ruling is to eliminate automatic gratuities. By permitting large par-

ties and banquets to leave tips subject to their discretion, restaurants avoid having to pay employees higher hourly wages, which also affect overtime rates. Additionally, restaurants avoid the payroll and tax implications discussed above.

Discontinuing the use of automatic gratuities, however, may come with a cost. Guests might opt not to leave tips in accord with custom and practice. Undoubtedly, some patrons find it more difficult leave a \$200 tip on a \$1,000 bill than a \$20 tip on a \$100 bill, let alone a \$2,000 tip on a \$10,000 bill. This could result in employees not being adequately compensated, or at least not compensated to the extent they were prior to the IRS’s ruling.

One strategy to minimize this risk is to provide suggested tip amounts. Restaurants do not run afoul of the IRS’s ruling by listing suggested tip amounts beneath the signature line on their bills, so long as the actual tip lines are left blank and guests’ tips are voluntary.

In doing so, restaurants remind their guests that tips are necessary to adequately compensate restaurant employees. At the same time, suggested tip amounts ensure that the payments are free from compulsion and guests have the unrestricted right to determine the amount. They are free to tip the same, more, or less than the suggested tip amounts; indeed, they may choose to leave no tip at all.

Another strategy is to list the desired tip as the lowest or second-to-lowest suggested amount. For example, if a restaurant previously had a 20 percent au-

2. *Id.*; see also 29 U.S.C. § 203(m); 29 C.F.R. § 531.59(b) (providing regulations governing the FLSA’s tip wage credit).

3. Rev. Rul. 2012-18, 2012-26 I.R.B. 1032; see also 26 U.S.C. § 45B (providing the FICA tip credit).

automatic gratuity, it may want to consider suggesting tip amounts of 18, 20, and 22 percent of the bill. A guest may feel more comfortable leaving a 20 percent tip in this situation than if the suggested tip amounts are 15, 18, and 20 percent.

Continue using automatic gratuities, but pay employees at least the applicable minimum wage. Finally, restaurants could address the IRS's ruling by continuing to use automatic gratuities but paying employees at least the applicable minimum wage. The effect of the IRS's ruling is that if a restaurant continues to use automatic gratuities, employees serving these parties

are no longer eligible for the tip credit.

Recognizing that many employees serving large parties and banquets often earned more than the minimum wage when automatic gratuities were distributed as tips, restaurants may want to pay above the minimum wage. For example, if a restaurant's employees typically earned \$4.95 per hour plus a portion of the automatic gratuity equaling \$15 per hour, the restaurant may want to offer employees a flat wage rate of \$20 per hour to serve large parties or banquets where automatic gratuities are assessed.

Restaurants should be especially mind-

ful of employees performing dual duties. When the automatic gratuity applies to some customers but not others in the same setting, servers are performing tipped and non-tipped work.

Because the tip credit can be taken only for employees performing tipped work, it is all but impossible to determine these employees' hourly wage. The best solution is for restaurants to micromanage employees' schedules to prevent them from simultaneously serving both kinds of patrons. ■

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