

EMPLOYMENT LAW ALERT
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**TIPS VS. SERVICE CHARGES: THE IRS SERVES
A NEW RULE TO THE RESTAURANT INDUSTRY**

On January 1, 2014, the IRS will begin enforcing a rule that significantly impacts the tax treatment of automatic gratuities collected by establishments at which tipping is a customary practice. If an establishment collects a mandatory, fixed gratuity (i.e., a fixed tip on a large party) which is distributed to employees who render services (e.g. waiters, bussers, bartenders, etc.), the fixed gratuity will be treated as a service charge and will be characterized as wages for FICA tax purposes.

TIPS VS. SERVICE CHARGES: WHAT'S THE DIFFERENCE?

Last year, the IRS clarified the difference between tips and service charges for FICA tax purposes and determined that amounts automatically added to a bill are service charges rather than tips and must be treated as FICA wages to the employee. The distinction between tips and service charges is important because there are different payroll reporting requirements, and the employer's share of FICA taxes paid on tips is eligible for an income tax credit, but FICA taxes paid on service charges are not.

Specific guidelines were issued establishing four factors for determining when a customer's payment is a tip. Absent any one of the following, it is likely to be characterized as a service charge:

- ▶ The payment was made free from compulsion;
- ▶ The customer has the unrestricted right to determine the amount;
- ▶ The payment was not the subject of negotiation or dictated by the employer policy; and
- ▶ Generally, the customer has the right to determine who receives the payment.

In other words, an automatic gratuity is a service charge and not a tip if:

- ▶ The establishment imposes a mandatory gratuity based on the number of patrons comprising the customer's party (e.g., parties of eight or more);
- ▶ The establishment dictates the amount of the gratuity (e.g., 18% of the total bill before taxes); or
- ▶ The customer cannot designate who receives the gratuity (e.g., the customer pays the house).

WHAT SHOULD EMPLOYERS DO?

When a service charge is collected, employers must:

- ▶ Report the amount of the service charge distributed to employees as FICA wages;
- ▶ Withhold the employee's share of FICA taxes from each payment; and
- ▶ Pay the employer's share of FICA taxes with respect to each payment.

Also, because the payment will not be characterized as a tip, the employer will not receive a dollar-for-dollar income tax credit with respect to its share of FICA taxes; the credit is available only for FICA taxes paid with respect to tips reported by employees.

OTHER CONCERNS

To determine whether a tipped employee receives the statutory minimum hourly wage, tips reported by the employee are considered by the employer as a tip credit. If varying amounts of service charges are treated as wages, calculating the hourly wage for each pay period will be difficult, as will calculating overtime pay with respect to a varying hourly wages.

It is not clear whether service charges that may vary in frequency and amount from payroll period to payroll period – essentially periodic mini-bonuses – are “regular” wages or “supplemental” wages for income tax withholding purposes.

Members of the hospitality industry are employing different strategies to comply with the new enforcement initiative. At one end of the spectrum, some establishments are ensuring that gratuities adhere to all the factors set forth in the published guidance (e.g., by dispensing with the practice of imposing a mandatory gratuity). At the other end, others are prohibiting the practice of tipping altogether and opting to charge customers a mandatory fixed-percentage service charge, keeping the service charge for itself, and paying employees the statutory minimum wage.

Regardless of the policy you decide to adopt, be sure to consult your advisor with any questions, and to ensure proper reporting.

If you have any questions about this alert, please contact one of the authors, [Gary M. Feldman](#) or [Brian L. Gaudet](#), or a member of our [Employment Law Practice](#).

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