

2014 IRS TIPPING RULES: RESTAURANT AND HOSPITALITY

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January 1, 2014 marked the official effective date of new IRS rules regarding tipping. This new ruling, Ruling 2012-18, was actually issued in 2012, but restaurants lobbied the IRS to delay implementing the new rule until the beginning of 2014. Revised Ruling 2012-18 is designed to further distinguish between tips and service charges and explain how automatic tips (service charges) should be taxed. This applies to a lot of restaurants that impose mandatory service charges for larger parties, as well as banquet operators and hotels that charge fixed “gratuities” for certain events or larger parties. Those service charges and fixed gratuity charges for large parties may now have to be treated as part of employees’ wages, among other considerations.

According to a previous IRS ruling (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 service 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 apply to automatic gratuities that are assessed for large parties at a restaurant or banquet setting.

This new ruling will affect restaurants and others in the hospitality business in a variety of ways. First some background. For the past twenty years, one of the tax benefits enjoyed by restaurants came from applying 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, Rev. Rule 2012-18 means that the credit would not apply with respect to automatic or fixed service charges and gratuities, 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 instead they should be reported as wages. This also means that while completing the “Employer's Annual Information Return of Tip Income and Allocated Tips” (IRS Form 8027), 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. Further, 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 differ from the treatment that would have applied if the charge was considered a tip.

In addition, any fixed service charge has to go through the payroll process and the wait staff cannot be “cashed out” at the end of the day. Since the service charges have to go through payroll, taxes need to be withheld at that time factored into the hourly wages.

Of course all of this begs another question: since the service charges are now part of payroll, what is the effect on the employees’ minimum wage and overtime status? Well, if an employee is working a shift where they earn a service charge, the employer may not take advantage of the tip credit because the employees are not earning any “gratuities” (as such term is defined by the Internal Revenue Code and the regulations underlying the Fair Labor Standards Act). Further, the employee must be paid the regular minimum wage for the time spent working the banquet or private event or large party. Also keep in mind that since the service charges is not a “tip”, employers may be entitled to keep the service charge in lieu of paying it out to the staff. But if the restaurant pays out the service charges to employees, the restaurant 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.

There are other complexities to this revised regulation: in restaurants where employees multitask by serving both smaller “traditional tipping” parties along with larger parties that are automatically tagged with the fixed service charge, there is a question about whether or not this type of shift work would be considered to be engaging in a “customarily and regularly tipped occupation”. Accordingly, employers who have this type of service could be exposed to state and federal audits, as well as civil litigation from employees if they don’t treat the overtime properly. It is probably best to avoid this headache by trying to schedule around it with the wait staff. One other point to consider: depending on the state, if a restaurant imposes a service charge on a bill, it may very likely be subject to state and local sales taxes.

So what can a restaurant or other hospitality provider do to reduce all these complexities? Consider the following tipping tips:

- Instead of a mandatory service charge, utilize a “suggested gratuity” but do not add it to the total on the receipt and allow the customer to voluntarily indicate the tip.
- Charge sales tax on all service charges, regardless of the amount paid to the employee.
- Follow the lead of many major restaurant chains and get rid of all service charges and automatic gratuities.

In conclusion, anyone in the hospitality industry that imposes a “mandatory gratuity” should consider changing their policies. If not, the provider needs to consult with their legal and tax professionals to make sure they are properly treating these charges from a tax and labor perspective. Failure to properly adhere to applicable law can create an expensive problem that will have a negative effect on the service provider’s bottom line.