

Duff on Hospitality Law

Mandatory Tipping - When is a Tip Not a Tip?

By Greg Duff on 1.29.14 | Posted in Food and Beverage

I'm pleased to introduce another guest author from local accounting firm [Clark Nuber](#). Julie Eisenhower is an audit and accounting principal specializing in the hospitality industry. We're grateful that Julie has offered to share her experience and knowledge with our readers. Welcome, Julie, and thank you for today's post on this important revenue ruling. – Greg

IRS Guidance Effective January 1, 2014

In a recent [Revenue Ruling](#) that took effect on **January 1, 2014**, the IRS provided guidance on the difference between tips and service charges. This guidance may cause accounting for mandatory tips on large dinner parties or banquet bills to be more costly and complicated.

Now is the time for restaurateurs and hoteliers to reevaluate their policy for mandatory tips. Revisions to the policy may be necessary after considering the IRS's definition of a *tip* vs. a *service charge*, the tax implications involved, as well as accounting and reporting requirements.

Tips vs. Service Charge (i.e., Wages)

A hotel or restaurant classifying a payment as a “tip” doesn't necessarily make it so. The IRS may determine through its independent review of facts and circumstances that the payment is actually a service charge. If the service charge is distributed to the employee in the course of employment, the service charge is considered “wages” for FICA tax and other purposes.

The Revenue Ruling lists the factors that the IRS will consider when evaluating whether a payment is a tip or service charge. To be considered a tip, the following must be present:

- The payment is made free from compulsion
- The customer has the unrestricted right to determine the amount
- The payment is not the subject of negotiation or dictated by employer's policy
- The customer has the right to determine who receives the payment

The [Revenue Ruling](#) clarifies that automatic or mandatory tips are service charges (i.e., wages) and cannot be treated as tips due to the fact that the customer is restricted from determining the amount of the tip and did not make the payment free from compulsion.

Tax Implications

So why does it matter if the customer payment is defined by the IRS as a service charge vs. a tip?

If the payment is a tip, the current law continues to apply, making it the responsibility of the employee to report all tips received in any calendar month to their employer by the 10th of the following month. The employer is required to pay FICA tax (Social Security and Medicare) on these tips. The good news is that a Washington State employer is allowed a FICA Tip Credit for all FICA tax paid on its employee tip income.

Like tip payments, service charge payments distributed to an employee for their services (wages), are subject to employer FICA tax obligations. However, since these payments are not tips, any FICA tax paid on the service charge would not be subject to the FICA Tip Credit.

Under Washington's State Excise Tax [Rules](#), tips representing donations or gifts by customers that are clearly voluntary are not part of gross revenue subject to tax. However, mandatory tips added to the sales price by the seller – whether labeled service charges, tips, gratuities or otherwise – must be included in the gross sales price and are subject to both the retailing business and occupation tax and retail sales tax. Consistent with the Washington State Excise Tax Rules, mandatory tips are included with gross revenue subject to income tax for Federal tax reporting purposes, while any related payment to the employee is a deduction against income.

Recommendations

To meet the definition of a tip by the IRS and Washington State, restaurants and hotels should consider revising their policy for adding mandatory tips on large parties or banquet bills and instead include sample calculations of tip amounts on the bottom of its receipts provided to customers. This will demonstrate the customer's unrestricted right to determine the amount of the tip and that it was made free from compulsion.

If the restaurant or hotel continues their policy of adding mandatory tips to large dinner party or banquet bills, special care should be taken to make sure the accounting system is correctly accounting for these payments as gross revenue when the payment is received and wages to employees when distributed to them. These payments should be segregated from tip payments in order to simplify both State and Federal income tax reporting requirements.

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Restaurateurs or hoteliers should evaluate the risks and rewards of adding mandatory tips to customer bills. Is the tax obligation or the reduction in the FICA Tip Credit significant? Is accounting and reporting of service charges as wages cumbersome? Are you including the statutorily required guest and customer disclosures? Taking the time to evaluate your policy now may help you avoid possible IRS scrutiny later.

If you have questions about this important ruling and its application to your hotel or restaurant please contact [Greg](#).

Tags: Service Charges, Social Security and Medicare, Tips