

Automatic Gratuities

Tips or Service Charges?



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A RECENT INTERNAL REVENUE SERVICE (IRS) REVENUE RULING SHOULD FORCE CLUBS AND OTHER FOOD AND BEVERAGE SERVICE ESTABLISHMENTS TO EVALUATE GRATUITY POLICIES.

Revenue Ruling 2012-18 issued on June 20, 2012 is an attempt to clarify and update existing guidelines and the distinction between tips and service charges.

The revenue ruling states that the IRS will continue to apply existing criteria in order to determine whether a payment is a tip or a service charge. Under Revenue Ruling 59-252, four requirements must exist for a payment to be classified as a tip. Those four requirements are:

1. The payment must be made voluntarily without any compulsion
2. The customer must be free to determine the amount of the payment
3. The payment cannot be dictated by employer policy or be subject to negotiation, and
4. The customer must generally have the right to determine who is entitled to receive the payment.

The absence of any of these actions indicates that the payment may be a service charge rather than a tip and therefore includable in the employee's wage base for overtime. As a result the employer may not take advantage of the 'tip credit' permitted for employees who regularly receive tips or the 'fica'

tip credit as a tax credit on their income tax returns.

Clubs have traditionally forbidden the practice of 'cash' tipping in their food and beverage establishments, instead, electing the use of an automatic 'gratuity' charge on the member's check.

Clubs often disclose to the members the policy on tipping through such statements as, "For your convenience a recommended gratuity of ____% is added to this check. The payment of this gratuity is subject to your complete discretion and may be increased, decreased or eliminated entirely." In this way, the club is permitting the member to have 'complete discretion' as to the payment of the tip or gratuity.

However, it is unlikely the customer or, in this case, the member really thinks about whether this payment is discretionary or not. In some cases, members never even sign their checks and there is therefore no evidence that the member has approved the amount. Furthermore, members for the most part have very little knowledge or influence as to how the tip or gratuity is pooled and distributed.

The point to take away is this: Many clubs which use this practice may not be adequately following the rules in order for the payment to be seen as a tip from the perspective of the IRS. Documentation is critical for supporting a club's position that the automatic gratuity is a tip.

Labor Department regulations define a tip as:

“A tip is a sum presented by a customer as a gift or gratuity in recognition of some service performed for him. It is to be distinguished from payment of a charge, if any, made for service. Whether a tip is to be given, and its amounts are matters determined solely by the customer, and generally he/she has the right to determine who shall be the recipient of the gratuity.”

Labor Department regulations permit the practice of pooling, splitting or sharing tips as long as the employees in the pool customarily and regularly receive tips. Employees who customarily and regularly receive tips are waiters, waitresses, countermen, busboys and service bartenders.

Also likely included would be captains and maitre d's who regularly provide service to dining club members. The tip pooling/distribution should be clearly understood by the service employees and no portion of the tips may be retained by the employer. Furthermore, if the employer is taking a tip credit against the employees' hourly rate, employees must be informed about the specifics of their hourly wage, tip credit and net hourly wage.

In addition, since tips are considered the property of the employee receiving them, tips due to employees must be paid no later than the next regular payroll without any regard to their reimbursement from club members.

Since many clubs have a stated policy that permits the member to increase, decrease or eliminate the gratuity charge entirely, any instances where this occurs should be

service charges. Massachusetts and New York have such laws that require, in substance, that gratuities, tips or service charges in lieu of tips be fully distributed to food service employees. In the case of service charges, described in the Massachusetts law, if the patron reasonably expects that the service charge “in lieu of a tip” is distributed to the service employees, then it should be fully distributed.

Club rules regarding gratuities, tips and service charges should be clearly defined to both members and employees alike. A service charge that is a fee for service and not to be distributed should be clearly characterized as such.

Perhaps a more interesting discussion lies in determining the best methods to compensate service employees. Not surprisingly, the answer is not the same for every club and there are really only two issues to consider. First, what the best way is for the members to pay for the cost of what should be the best service experience. Second, what the best way is to reward service employees for providing that service.

There was a time when compensation methods were designed to look like those of commercial restaurant operations, namely minimum wage, net of tip credits, plus charge tips entered by the member or discretionary automatic gratuities.

For several years now, clubs have been moving toward paying service employees a fixed hourly rate since food and beverage sales have been relatively flat or declining and, with the element of seasonality, tips or gratuity amounts are unpredictable. Many clubs have eliminated tips or service charges

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maintained in separate file as evidence in case a wage and hour or IRS audit should occur.

Finally, the charge ticket that includes the imprinted automatic gratuity should be signed by the member evidencing the member's approval for the payment of the gratuity.

Remember that there must be documentation to show that the payment is voluntary; the club member is determining the amount by having the option to increase, decrease or eliminate entirely; the payment or distribution is not dictated by employer policy or subject to negotiation, and the club member generally has the right to determine who is entitled to the payment. If even one of these four criteria is not met, then the payment is not a gratuity or tip.

Club management should be aware of any state laws regarding the employer's handling of gratuities, tips and

from the members' charge ticket and replaced them with a fixed monthly service charge or they have built the total cost of service into the dues structure.

Whatever method a club chooses, it should be sure that it is in compliance with all rules and regulations, whether they are IRS, wage and hour, or state sales tax. **BR**

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