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The Tip of the IRS-berg: The Misclassification of Mandatory Service Charges

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Service charges need to be reported differently than tips under the IRS guidelines, and under a Revenue Ruling that went into effect on the first of the year, and pursuant to IRS guidelines, "service charges" need to be reported differently than "tips." It is therefore vital that employers with tipped employees – namely, those in the service industry – properly classify service charges and treat them according to IRS guidelines and rules. But what exactly are service charges, and how do they differ from tips?

Is That a Service Charge or a Tip?

Some employers, particularly restaurants and eateries, impose a mandatory gratuity on large parties (often eight or more patrons) that is automatically added to the final bill. An employer in the retail industry may tack on a mandatory delivery charge. Your favourite underage Canadian pop singer's preferred nightclub might have a bottle service charge added to orders. Hotels and resorts might charge guests a room service charge for meals ordered and enjoyed in their rooms. These are all examples of "service charges."

Under federal regulations and IRS guidelines, a "tip" is voluntarily given by a customer as a gift or gratuity in recognition of a service performed by the server. Conversely, compulsory service charges that are automatically added to bills are, by definition, not voluntary. In evaluating whether an amount left by a patron is a tip or service charge, the IRS will look at certain factors considered hallmarks of tips. These are: (1) the customer makes the payment of his or her own free will (free from compulsion by the employer); (2) the customer has the unrestricted right to determine the amount he or she leaves; (3) the payment is not the subject of negotiation or in any way dictated by some employer policy; and (4) in general, the customer gets to decide who receives the payment. The absence of any of these factors will create doubt that the payment is in fact a tip, and may indicate that the employer should classify the payment as a service charge, even if the payment is distributed to employees.

So Why Should Anyone Whose Initials Aren't "IRS" Care?

The distinction is important because the improper designation of mandatory service charges as tips rather than wages will have tax repercussions on the employer. Tips are the property of the employees who receive them, and cannot be used by the employer for any purpose that is not permitted by statute (federal or state). Conversely, service charges are gross receipts of the employer, and the employer is free to use them however the employer sees fit. Therefore, when the employer chooses to distribute these amounts collected from service charges to employees, the distributed amounts are wages, not tips, and must be categorised and treated as such, including the withholding of proper taxes for the employee and payment of payroll taxes by the employer. As employers know (and the IRS won't let them forget), "non-tip wages are subject to social security tax, Medicare tax, and federal income tax withholding."

Additionally, in states where tip credits are allowed, distributed service charges (which are wages) do not count as tips for purposes of meeting that credit. The Fair Labor Standards Act (FLSA) provides that, for tipped employees in most states, the FLSA's requirement that employees be paid minimum wage can be met through a tip credit. A tip credit is where an employee is paid at least $2.13 per hour plus earns an additional amount in tips (or the employee's wage is otherwise supplemented by the employer) such that his or her total compensation is equal to or exceeds the federal minimum wage. Payments from service charges distributed to employees as non-tip wages are not

tips and cannot be calculated as such in determining whether the tip credit has been met. However, as a reminder, not all states allow tip credits. In fact, Oregon expressly forbids employers from utilising tip credits.

So What's an Employer to Do?

Some employers may undoubtedly do away with mandatory service charges. However, for employers who continue to utilise them into 2014 and beyond, a review of business practices is in order to ensure that amounts collected from service charges are being treated appropriately under the IRS' standards and guidelines, including the payments and withholding of all applicable taxes.

Sean Ray is an attorney at Barran Liebman LLP, defending employers against discrimination complaints, sexual harassment lawsuits and retaliation claims. In addition to litigation, Sean also works with employers to ensure compliance with changes in the law, including drafting and revising their employee handbooks and providing customised trainings to help businesses prevent workplace grievances. Sean regularly writes about employment law cases and decisions, and currently votes as the Multnomah Bar Association's Young Lawyers Section Delegate to the American Bar Association. He received his B.S. in Mechanical Engineering from the University of Portland, and earned his J.D. at the University of Oregon.