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IRS Ruling Says Auto Gratuities Are Treated as Wages, Not as Tips

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The Internal Revenue Service (IRS) recently issued Rev. Rul. 2012-18 and interim guidance in Announcement 2012-25 relating to the treatment of auto gratuities as service charges. Businesses may have to change automated or manual reporting systems in order to comply with the proper treatment under the Revenue Ruling. The IRS is granting additional time in certain circumstances for businesses not currently in compliance to amend their business practices and make needed system changes.

Background

Special income and employment tax reporting rules apply with respect to tips received by employees in the service industry. Sections 3121(a) and (q) of the Internal Revenue Code provide that cash tips received by an employee are wages for FICA (social security) tax purposes, and, therefore, are required under section 6053 to be reported to the employer by any employee who directly or indirectly receives cash tips (including credit and debit card tips) of at least $20 per month.

Employers are required to collect income tax, employee social security tax and Medicare taxes on tips reported by employees. Employees are required to report their tips to their employer on Form 4070 by the 10th day of the month after the month in which the tips are received. Many businesses collect information from employees on tips on a daily basis. Accurate reporting of tips is a known compliance issue and the IRS has established voluntary compliance programs for employers to reduce their audit risks with respect to the underreporting of tips. In contrast, collected service charges that are then distributed by the employer to employees are treated as wages subject to the normal reporting and withholding rules.

In Revenue Ruling 2012-18, updated question-and-answer guidance is provided for distinguishing between tips and service charges for reporting and withholding purposes, as well as the special business tax credit under section 45B for the excess employer social security tax an employer pays on the tips. The Revenue Ruling includes guidance on the treatment of automatic service charges, regularly referred to in the service industry as “automatic gratuities” or “auto gratuities.”

Q&A 1 of Rev. Rul. 2012-18 provides that an employer's characterization of a payment as a "tip" is not determinative and reaffirms the factors in Rev. Rul. 59-252, which are used to determine whether payments constitute tips or service charges. Q&A 1 of Rev. Rul. 2012-18 provides that after consideration of all of the surrounding facts and circumstances, the absence of any of the following factors creates a doubt as to whether a payment is a tip and indicates that the payment may be a service charge:

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

Rev. Rul. 2012-18 contains an example illustrating the distinction. A restaurant policy of automatically adding an 18% charge to the bill of parties of six or more is a service charge because (i) the customer did not have the unrestricted right to determine the amount of the payment, which was dictated by employer policy; and (ii) the customer did not make the payment free from compulsion. On the other hand, a restaurant bill that includes sample calculations of different tip amounts (e.g., 15%, 18%, or 20%) but leaves the actual tip line blank is a tip because (i) the customer was free from compulsion to enter any amount on the tip line or leave it blank; (ii) the customer and the restaurant did not negotiate the amount nor was the amount dictated by restaurant policy; and (iii) the customer generally determined who would get the amount.

Although long-standing prior guidance has included examples of certain types of similar automatic service charges that are passed on by the employer as tip income, this appears to be the first direct guidance on this type of automatic tip added to the bills for large parties.

Treatment of Service Charges in Tip Examinations

Pursuant to the interim guidance memo issued to the field on June 7, 2012 (SBSE-04-0612-057) and released to the public in Announcement 2012-25, when performing a tip examination, examiners must ensure that distributed service charges, including auto gratuities described in the Revenue Ruling, are properly characterized as wages and not tips. Service charges are not to be included in any calculation that arrives at an hourly tip rate, a tip rate calculated on a percentage of sales, or any other rate determination method. Incorrectly characterized service charges are to be recharacterized and an adjustment made to the Form 941 via employment tax report Form(s) 4666 and 4668. The IRS acknowledges that in the past, due to automated or manual taxpayer business systems which failed to accurately classify payments, IRS examiners may have treated service charges as tip income for purposes of computing unreported tips or tip rates for voluntary tip compliance agreements. The interim guidance directs field agents to review existing tip compliance agreements to determine if distributed service charges have been incorrectly characterized as tips and amend those agreements.

Eligibility of Service Charges for the Tip Credit

Section 45B(a) provides that, for purposes of the general business credit under section 38, the credit for employer social security and Medicare taxes paid on certain employee tips is an amount equal to the "excess employer social security tax" paid or incurred by the employer. The term "excess employer social security tax" means an amount equal to the employer's FICA tax obligation attributable to reported and unreported tips in excess of those treated as wages for purposes of satisfying the minimum wage amount as in effect on January 1, 2007, (i.e., $5.15 per hour). The interim guidance provides that service charges

are not eligible for the tip credit claimed on Form 8846, and are not eligible for the general business credit claimed on Form 3800.

Effective Date, Action Required and Comments

Rev. Rul. 2012-18 is effective immediately and applicable retroactively. However, because the IRS is aware that some businesses may have to change automated or manual reporting systems in order to comply with the proper treatment of service charges as specified in Q&A 1 of Rev. Rul. 2012-18, the interim guidance provides that, in specified limited circumstances, examiners are directed to apply Q&A 1 of Rev. Rul. 2012-18 prospectively to amounts paid on or after January 1, 2013.

In determining whether Q&A 1 of Rev. Rul. 2012-18 should be applied prospectively, examiners are to consider whether the set of facts and circumstances at issue was directly addressed in prior guidance and whether the business needs additional time to amend its business practices and make system changes to come into compliance. As it appears that the auto gratuity facts in the example of Q&A 1 discussed above were not addressed in prior guidance, the prospective application should be available to those facts.

In preparation for Rev. Rul. 2012-18 and the interim guidance, employers are encouraged to take the following actions:

- Ensure that adequate processes and changes to automated or manual reporting systems and business practices are in place for properly distinguishing between service charge wage income and tips; and
- Review records to consider whether service charges have incorrectly been treated as tip income and whether any adjustments to Form 941 are necessary.

The IRS is seeking public comments regarding this interim guidance and whether additional time is needed to ensure that systems are compliant. Comments on the interim guidance may be submitted to the IRS on or before September 24, 2012 either electronically or in writing.

If you have questions, please contact the Pillsbury attorney with whom you regularly work or the authors:

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