



September 2013

IRS Rules on Automatic Gratuities

Guidance for Beverage Retailers

THE RULE

On June 25, 2012, the IRS issued [Rev. Rule 2012-18](#), classifying automatic gratuities as service charges. Service charges are considered to be *wages*, not *tips*, and are subject to payroll tax withholding. **This includes automatic gratuities leveraged for parties of a certain size.**

This rule will take effect January 1, 2014.

WHAT THE IRS CONSIDERS A TIP

The IRS differentiates between what it considers a “tip” and a “service charge.”

For a payment to be considered a *tip*:

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

ON-PREMISE LICENSEES ARE ENCOURAGED TO:

- 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;
- Review records to consider whether service charges have incorrectly been treated as tipped income and whether any adjustments to Form 941 are necessary;
- Consider whether it is in their best interest to remove automatic gratuities and replace them with a calculation of three suggested tip rates: 15%, 18%, and 20% (which must be clearly identified for reference purposes only so as not to appear to be mandated);
- **Inform their employees of final changes to policy before they take effect January 1, 2014;** and
- Consult with their tax advisor or attorney to ensure their policies are in compliance with the IRS guidance and practices.

COMPLIANCE

As consequence of the rule, there is speculation that the IRS will more closely examine merchant compliance. As a reminder, service charges are considered wages, and, therefore, not eligible for the FICA Tip Credit. Auto-gratuities paid for catering, banquets, weddings and other amounts mandated by employer policy would also likely be covered by this new rule.

RESOURCES

[IRS Revenue Bulletin: 2012-26](#)

[IRS Memorandum for All Field Examination Operations: Interim Guidance on Tips vs. Service Charges Employer Payroll Tax Obligations for Tipped Employees](#)