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**Automatic Gratuity Coming to an End?
New IRS Rule Frustrates Industry Practice**

By: [Jonathan M. Boulahanis](#)

This week Americans across the country rolled out the red carpet and welcomed 2014 in style. For many, that meant getting together with friends, family, and loved ones, and celebrating at restaurants or bars across the country. In accordance with what has become a customary practice in the bar and restaurant industry, when the bills came for these groups of people celebrating, an 18-22% gratuity or service charge was added to the end of the bill. The reasoning for business owners is three-fold: (1) it is advantageous to the servers to ensure that they receive proper gratuity on a large bill; (2) it is the servers' responsibility to self-report their tips above \$20 to their employer, including the automatic gratuity charges; and (3) the employers could use that amount toward the tip-credit allowed under Section 45B of the Internal Revenue Code to offset social security.

Starting January 1, 2014, though, the restaurant and bar industry is facing a drastic change in its reporting requirements that may put the automatic gratuity practice to an end. On December 12, 2013, the IRS issued a ruling changing the automatic gratuity or service charge from tip wages to non-tip wages.

"Service charges added to a bill or fixed by the employer that the customer must pay, when paid to an employee, will not constitute a tip, but rather constitute non-tip wages. These non-tip wages are subject to social security tax, Medicare tax, and federal income tax

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withholding. In addition, the employer cannot use these non-tip wages when computing the credit available to employers under section 45B of the Internal Revenue Code, because these amounts are not "tips." IRC Topic 761.

The ruling could have a profound impact on the industry, especially those that have significantly utilized this practice. For example, the nightclub industry almost always has added an automatic gratuity or service charge on bottle service. Most restaurants with a high-volume delivery business add an automatic delivery charge. Restaurants and banquet halls usually add the amount to large parties. Hotels usually add luggage service charges. If these practices are continued in the new year, the amount must be classified as non-tip wages.

Practically, in order to continue the practice, the industry will need to evaluate their current reporting practices and procedures. The automatic gratuity will need to be classified differently than other wages, and likely paid with other non-tip wages. The social security credit will no longer apply for such charges.

For the employees, some see the change as a gigantic risk as the consumer will decide an appropriate tip amount on a large bill. According to the Wall Street Journal, some restaurants are already experimenting with stopping the practice altogether, including Darden Restaurants, owner of Olive Garden, Texas Roadhouse, and other chains. (See, Jargon, J. (2013, September 4) IRS Rule Leads Restaurants to Rethink Automatic Tips. The Wall Street Journal, online). According to the New York Times, some restaurants are changing their business model altogether, and eliminating tips and just paying their servers a higher hourly amount. (See, Wells, P. (2013, September 3) Leaving a Tip: A Custom in Need of Changing? The New York Times, p. A1). In Chicago, that has been the practice of highly touted restaurants such as Next and Alinea. Anyway you look at it, this IRS ruling may very well change the bill that your group receives when you head out to ring in 2015.

The IRS ruling will have a ripple effect and require changes throughout the industry. For those affected by the change that would like to discuss the new reporting procedures and implications, you can contact the Clark Hill Food and Beverage team and Jonathan Boulahanis at (312) 985-5930, or jboulahanis@clarkhill.com.

<http://www.irs.gov>

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