Updated IRS guidance explains the difference between tips and distributed service charges

Rev Rul 2012-18, 2012-26 IRB; Ann. 2012-25, 2012-26 IRB

In updated guidance, IRS explains how to differentiate between tips which are subject to special FICA tax rules, and distributed service charges, which must be treated as wages, not tips. In general, such charges are mandatory add-ons to food and drink bills that are distributed by the employer to wait staff. Although the guidance generally is effectively immediately and applicable retroactively, it may be applied prospectively by auditors, i.e., only to amounts paid on or after Jan. 1, 2013, if certain conditions are satisfied.

Background on tips in general. In general, Code Sec. 3101(a) requires employers to deduct and pay over the employee portion of the FICA tax. However, under the special rule of Code Sec. 3102(c)(1), the withholding requirement applies only to the tips included in a written statement furnished by the employee to the employer under Code Sec. 6053(a), and only to the extent that collection can be made by the employer by deducting the amount of the tax from wages paid to the employee (excluding tips). Under Code Sec. 3121(q), tips received by an employee in the course of employment are considered remuneration for that employment and are deemed to have been paid by the employer for purposes of the employer portion of the FICA taxes. The remuneration is deemed to be paid when a written statement including the tips is furnished to the employer by the employee under Code Sec. 6053(a). However, if the employee either did not furnish the statement or if the statement furnished was inaccurate or incomplete, in determining the employer's FICA tax liability for the tips, the remuneration is treated as paid on the date on which notice and demand for the taxes is made to the employer by IRS.

Under Code Sec. 45B(a), for purposes of the Code Sec. 38 general business credit, 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. Excess employer social security tax means any tax paid by an employer under Code Sec. 3111 (both social security tax and Medicare tax) on its employees' tip income without regard to whether the employees reported the tips to the employer. Thus, the Code Sec. 45B(a) credit is available for unreported tips in an amount equal to the excess employer social security tax paid or incurred by the employer. No credit, however, is allowed to the extent tips are used to meet the federal minimum wage rate that was in effect on Jan. 1, 2007 ($5.15 an hour). The credit is available with respect to FICA taxes paid on tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption, if it is customary for customers to tip the employees.

Tip versus compensation controversy. An issue addressed by several IRS rulings is whether an amount is a tip or actually compensation (e.g., Rev Rul 59-252, 1959-2 CB 215, dealing with negotiated amounts to be distributed to a banquet facility's employees, and Rev Rul 64-40, 1964-1 CB 68, dealing with a club's solicitation by pledge cards for an employee Christmas fund). In general, these rulings conclude that to be treated as a tip, (1) an amount must be made “free from

compulsion," (2) the customer must have unrestricted right to determine the amount of the tip, and (3) the contributions can't be the subject of negotiation or dictated by employer policy.

Rev Rul 95-7, 1995-1 CB 185, Q&A 2, deals with the specific question of whether Code Sec. 3121(q) applies where all tips must be turned over to the employer by the employees, and the employer, in turn, distributes the tips among all the employees. The ruling concludes that tips distributed in these situations are wages when paid by the employer, and that Code Sec. 3121(q) applies only to tips that are received and retained by the employee.

New guidance on tip versus distributed service charge. Under Rev Rul 2012-18, Q&A 1, an employer's characterization of a payment as a tip is not determinative for FICA purposes. For example, an amount called a tip actually may be a service charge distributed to employees (and thus should be treated as wages).

Rev Rul 2012-18, Q&A 1, provides that the criteria of Rev Rul 59-252, should be applied to determine whether a payment made in the course of employment is a tip or non-tip wages under Code Sec. 3121. Under the earlier revenue ruling, that 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:

(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.

To illustrate these rules, Rev Rul 2012-18, Q&A 1, provides an example of a restaurant whose menu explains that an 18% service charge will be added to all parties of six or more. The bill for a party of 8 includes an amount on the "tip line" equal to 18% of the price for food and beverages, the total includes this amount, and the restaurant distributes this amount to the waitresses and bussers. Under these circumstances, Rev Rul 2012-18, Q&A 1, Ex. A, concludes that the amount included on the tip line is a service charge dictated by the restaurant, not a tip. Rev Rul 2012-18, Q&A 1, Ex. B.

By contrast, where a restaurant merely includes sample calculations of tip amounts beneath the signature line on its charge receipts for food and beverages, an amount entered by a customer on the tip line is a tip within the meaning of Code Sec. 3121.

Rev Rul 2012-18, also carries updated rules for FICA taxes on tips, such as reporting and depositing of FICA taxes on tips, Section 3121(q) Notice and Demand issues, and the Code Sec. 45B credit.

Effective date and interim guidance for examiners. In general, Rev Rul 2012-18, is effectively immediately and applicable retroactively. In interim guidance to examiners, IRS explains that distributed service charges that have been characterized as tips should generally be recharacterized and an adjustment made to the Form 941 (Employer's Quarterly Federal Tax Return) under examination via employment tax report Form(s) 4666 and 4668. Service charges are not eligible for the credit claimed on Form 8846 (Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips), and are not eligible for the General Business Credit claimed on Form 3800. When calculating the amount of unreported tips for an employer-only assessment under Code Sec. 3121(q), examiners are told to ensure they do not include service charges in the Section 3121(q) Notice and Demand.

However, the interim guidance for examiners says that under very limited facts and circumstances, Rev Rul 2012-18, Q&A 1, should be applied prospectively, that is, only to amounts paid on or after Jan. 1, 2013. To the extent that Q&A 1 is applied without retroactive effect, examiners are told that employers won't have to pay any additional taxes. Also, employers that correctly treated service charges as wages are not entitled to a refund of any taxes they may have paid or will pay due to their proper reporting of service charges as wages.

In determining whether Rev Rul 2012-18, Q&A 1, should be applied prospectively, examiners are told 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.

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. Such existing agreements are not voided as a result of the interim guidance. Examiners may contact establishments possessing an agreement to conduct a tip rate review to consider the tips vs. service charges issue, but doing so will not constitute a “tip examination” within the meaning of an agreement. If distributed service charges were treated as tips, the agreement will be modified.

Ann. 2012-25, says that the prospective application of Rev Rul 2012-18, Q&A 1, is designed to give businesses not currently in compliance additional time to amend their business practices and make needed system changes. Ann. 2012-25, also says that IRS (1) is seeking public comments regarding this interim guidance and whether additional time is needed to ensure that systems are compliant; and (2) in a future announcement will also solicit public comments on proposed changes to its existing voluntary tip compliance agreements. Specifically, IRS is considering significant changes to the Tip Reporting Alternative Commitment (TRAC) program and other variations of TRAC agreements.