

Are You Adopting a Service Charge Model to Help Raise Wages?

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As lawmakers continue to increase the minimum wage in states and cities across the country, many hoteliers and restaurateurs are implementing service charges and tip pools in order to meet rising costs and help workers earn consistent and livable wages. If your company is considering making such a move, you will want to do your homework to avoid the negative headlines, legal complications and financial burden that can accompany improper implementation of service charge or tip pool policies. Today's post will focus on service charges.

Service Charges/Automatic Gratuities

The first and critical item to note is that a tip and a service charge are not interchangeable. Tips are generally considered to be discretionary (optional or extra) payments, as determined by a customer, and which are given to employees for service to the customer. [\[1\]](#) When a customer elects to add a 15% charge to his or her bill to be distributed to the employee (who provided service), it is generally a tip, and the employee's property.

When the business automatically charges a percentage of the bill or assesses fees that the customer must pay, and which are distributed to employees, such charges or fees will generally be considered to be a service charge and not a tip. [\[2\]](#) Service charges are considered wages by the IRS as well as many state and local governments. Employees carry the primary responsibility for tracking and reporting tips (although employers may still have FICA and allocation responsibilities) [\[3\]](#), but employers are required to properly account for service charges. If a business allows its employees to continue to receive tips while also assessing a service charge, the business may have responsibilities under both approaches. Standards may vary by jurisdiction, but statutes and ordinances governing service charges often require that:

- The business provides written notice to guests (for example, on menus, contracts and receipts) informing them (1) when a gratuity will automatically be charged in connection with service; (2) the percentage or fee to be charged; and (3) the percentage of the charge that is to be distributed to employees.
- The employer properly reports to tax authorities, other relevant agencies, and employees, the service charges distributed to employees as income.
- The business reports any portion of service charges that are retained by the business (if allowed in the jurisdiction) as gross receipts, and may be required to both charge and pay taxes on those receipts.

- Employers recognize that they cannot rely on taking the FICA tip tax credit for service charges that they may be able to take for reported tips. [\[4\]](#)

A business must also be aware of how its city or state limits the size of party that can be assessed an automatic gratuity or service charge; the amount of the service charge the business can retain; and how service charges are to be factored into the calculation of overtime rates. Still, the service charge model is often attractive to employers because they can typically include back-of-house employees when distributing service charges. Also, front-of-house staff who directly serve guests may benefit from more consistent wages because guests no longer exercise discretion as to whether they will provide a gratuity. Finally, because they are often treated as wages, service charges may be used to meet the minimum wage requirements in some jurisdictions.

Early indications are that the public is open to a service charge approach when it is clear that employees will benefit. However, in order to operate a profitable and competitive business, each individual company will be tasked with finding the right balance between wages, prices, and service charges that satisfies both guests and employees.

Issues surrounding service charges are complex, and you are advised to explore your company's unique and specific needs with your tax adviser or legal counsel if you are considering implementing a service charge for your business.

Additional Resources:

[Tips Versus Service Charges: How to Report](#)

[Fact Sheet #15: Tipped Employees Under the Fair Labor Standards Act \(FLSA\)](#)

[\[1\]](#) See, e.g., 29 C.F.R. § 531.52

[\[2\]](#) [Topic No. 761 Tips - Withholding and Reporting](#)

[\[3\]](#) *Id.*

[\[4\]](#) [26 U.S. Code § 45B – Credit for portion of employer social security taxes paid with respect to employee cash tips](#)

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