

IRS to Count Automatic Gratuities as Wages

by Joseph M. Donegan on September 27, 2013

The Internal Revenue Service has provided a great deal more guidance on how tips extended to waiters and waitresses, hair stylists, and other professionals should be reported for federal tax purposes. However, the agency recently announced a new policy governing the tax treatment of automatic gratuities, which may change the way that restaurants charge large parties in the future.

Under the new tax law, automatic gratuities - such as the popular 18 percent tax for large parties - will be treated and taxed as wages, rather than self-reported tips. Automatic gratuities - or service charges as they are now called - are those charged for large tables, and the charges are built into the bill and currently count as tips that are not subject to payroll tax withholding. Under the new rule, service charges will be subject to payroll tax withholding. This, in turn, may raise costs for restaurants, the Wall Street Journal reports.

Already, some restaurants are considering eliminating these types of tips altogether, including Darden Restaurants, which owns Olive Garden and Red Lobster. This scenario could also have an averse effect on waiters and waitresses who make less than the minimum wage, as these gratuities often help these workers at least reach minimum wage, the Daily Caller reports. The rule initially went into effect in 2012, but was pushed back to January 2014 to give restaurants time to comply with the new mandate.

"The change would mean more paperwork and added costs for the restaurants - and a potential financial hit for waiters and waitresses who live on their tips but don't always report them fully," according to the Journal.

The IRS says the absence of any of these four factors indicates that gratuity 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 the customer has the right to determine who receives the payment.