



STOKES WAGNER

ATTORNEYS AT LAW

ATLANTA • ITHACA • LOS ANGELES • PITTSBURGH • SAN DIEGO

What's in a Name?

Navigating Gratuities, Tips, and Service Charges

Hospitality guests have historically used gratuity to acknowledge their service staff's excellent work. Employees have come to expect and rely on gratuities, as they now often form the majority of their incomes. Restaurants also sometimes charge guests mandatory fees instead of, or in addition to, gratuity. Yet employers often mislabel, mishandle and commingle gratuities and service charges, which can have serious legal implications. Understanding the differences between a gratuity and a service charge is critical. Below, we demystify these payments and explain how to limit your exposure through best practices.

Gratuities are Voluntary.

Simply put, a gratuity is a voluntary amount paid by a guest in recognition of services performed. The amount of a gratuity is left to a customer's discretion and is optional. Because a gratuity is voluntary, the term "automatic gratuity" is a misnomer. Although the terms "tip" and "gratuity" have been used interchangeably, we prefer "gratuity," as it is industry standard.

Properly classifying a payment as a gratuity is essential, as certain states (including Arizona, California, Florida, Georgia, Massachusetts, New York, and Washington) do not subject gratuities to sales tax. It is also important to correctly identify which employees are eligible to receive gratuities, as litigation surrounding who can participate in a "tip pool" has become increasingly prevalent.

We have identified the following key traits of a gratuity or tip:

- Customer determines the amount;
- Not subject to sales or income tax;
- Not included in calculation of employees' overtime rate of pay;
- Employer responsible for withholding taxes only from those gratuities it administers through payroll (i.e. credit card tips and tip share); and
- Not considered "sales" and not reported on the employer's gross revenues.

Questions? Contact Stokes Wagner.

Best practices to limit exposure:

- Present the bill to the guest with the gratuity area left blank, so the guest may voluntarily write in the amount. Take this opportunity to also inform guests that gratuities are optional.
- You may provide “suggested gratuity” calculations, provided that the guest ultimately decides the amount.
- Be sure to use terms consistently on all payroll records to dispel any uncertainty surrounding the payment. For example, if you administer credit card gratuities or tip share through payroll, use the term “gratuity” on employees’ paystubs if that is the term used on guest bills.

Service Charges are Mandatory.

A service charge is a compulsory amount imposed by the venue, usually included as a percentage of the total bill. Unlike gratuities, guests are not given discretion to determine the amount or recipient. To further complicate matters, certain venues refer to service charges as “auto-gratuities” on bills. Remember, if the guest lacks discretion in the amount and recipient of the payment, it cannot be treated as a gratuity. Common examples of service charges in the hospitality industry include large-party charges at restaurants, bottle service charges at restaurants and night clubs, room service charges, and luggage assistance charges at hotels.

Key characteristics of a service charge include:

- Venue determines the amount;
- Recorded in gross receipts and subject to income tax;
- Included in calculating overtime rates of pay if distributed to employees; and
- Subject to employer and withholding taxes if distributed to employees.

Best practices for handling service charges:

- Some states and localities require employers to distribute 100% of service charges to customer-facing staff (for example, California and New York). Other jurisdictions allow the venue to decide whether to retain all or a portion of a service charge or to distribute some or all to employees (Georgia and Florida, for example). We recommend distributing service charges to service staff, even if you are located in a jurisdiction that allows the venue to keep a portion.
- If you distribute a portion of a service charge to employees, ensure they are paid within the same pay period they are earned.
- If you do decide to provide guests an option to tip on top of a service charge, provide a blank line on the bill for the guest to write in an “optional gratuity” rather than “additional” gratuity. The word “additional” incorrectly suggests that the service charge is also a gratuity.

- State and local regulations vary on the requirements for communicating service charges to guests on menus and receipts. We recommend plain language and 12-point font to ensure compliance across state lines.
- Never merge a mandatory service charge with a gratuity on a bill into one amount. Each payment should be clearly and separately identified on the bill.

States also differ regarding other fixed charges like delivery fees. Some states consider a delivery charge to be a gratuity if a reasonable person would believe the charge would rightfully belong to an employee, while others firmly label these amounts as service charges.

Bottom line: consult with counsel to ensure that your service charge and gratuity practices are compliant with the laws where you conduct business.