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IRS ruling may take gratuities off the menu

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By Patricia Sabatini / Pittsburgh Post-Gazette

Some diners view automatic gratuities as a convenience. For others, it's like being force fed.

Either way, the practice of automatically adding tips to bills for big groups -- often tables of six to eight people or more -- could quietly disappear following an IRS ruling that forces restaurants to classify such charges as wages, not tips.

"Say Goodbye to Automatic Gratuities" is how one law firm put it in an alert to the hospitality industry last year in anticipation of the ruling that's now set to take effect Jan. 1.

Florida-based Darden Restaurants -- operator of Olive Garden, Red Lobster, LongHorn Steakhouse, The Capital Grille and others -- said it would decide by yearend whether to eliminate automatic 18 percent tips for parties of eight or more at its some 2,100 locations.

The country's biggest casual dining chain already has dropped the practice at 100 of its restaurants in various markets across the nation. Instead, it prints suggested gratuity amounts on diners' receipts -- for 15, 18 and 20 percent of the total bill, excluding tax -- leaving the tip line blank for customers to fill in.

"We're testing this change in an effort to determine the best way to preserve tips for our employees while following the IRS guidance," spokesman Rich Jeffers said.

So far, diners have said they like seeing suggested tip amounts on their checks, he said.

"The feedback we're hearing from guests is that it is very convenient."

Darden began rethinking its tip policy after the IRS issued updated guidance further clarifying a decades-old rule that treats mandatory gratuities as wages, subject to payroll taxes. The agency planned to start enforcing the regulation in earnest this past January, but delayed the action until Jan. 1, 2014, to give businesses more time to comply.

The action could complicate record keeping and could end up raising payroll taxes for servers and restaurants where automatic tips continue to be imposed.

The ruling would have little or no impact on businesses' payroll taxes if waitstaff correctly reported all tip income to their employers as required by law, the IRS said. Practically speaking, however, taxes could go up if some workers have been underreporting their tips.

"If all tipped employees report 100 percent of their tips, the additional FICA [payroll] tax burden on the employer should be negligible, if any," the Internal Revenue Service said in an online Q&A on the issue.

"The employer is required to pay FICA taxes on non-tip wages and tip wages. Changing the characterization from reported tip wages to non-tip wages ... should not have a tax impact on the employer."

"That said, some tipped employees may not report all of their tips to their employer," the agency said.

Mr. Jeffers said Darden's policy review was not motivated by tax consequences, but rather a desire to do right by its employees.

"One attractive thing about the industry is you earn tips and receive them on a nightly basis," he said. "If it is categorized as a wage, it has to be held and paid out in a paycheck."

Because federal law allows employers to pay employees who also receive tips less than the standard minimum wage, restaurant servers typically count on tips for the bulk of their earnings.

The ruling -- which the IRS said was prompted in part by an increase in the use of automatic gratuities -- won't affect Pittsburgh-based restaurant chains Eat'n Park or Burgatory because neither currently adds tips to bills no matter how large the table.

At Big Burrito Restaurant Group -- the Pittsburgh-based operator of seven local Mad Mex locations, Kaya and three upscale restaurants -- tables of six or more are automatically charged a 20 percent gratuity, according to corporate chef Bill Fuller.

He said he wasn't sure whether the company would alter its policy because of the IRS ruling.

"We'll have to review it and ask our tax attorney what to do," he said.

Elimination of automatic tips undoubtedly would make many diners happy.

Ruth Hrehocik, a senior claims examiner at Healthcare Recoveries on the North Side, routinely organizes staff lunches and office parties where the cost of the gratuity is automatically included.

"What if you have poor service? Why should you automatically pay 18 percent?" she said. "I think you should be able to choose how much you tip depending on service."

For servers and other waitstaff, elimination of automatic gratuities raises the possibility of ending a shift in the hole if they are stiffed by a large table.

In Manhattan, many restaurants automatically add tips to all bills regardless of party size because of a large volume of tourists, particularly from Europe, where tipping at restaurants isn't customary.

"It's done to ensure those servers receive a gratuity," Mr. Jeffers said, noting that three Darden restaurants in Manhattan have an across-the-board automatic tip policy.

At Disney World in Orlando, Fla., the union representing food service workers had automatic 18 percent tips for parties of six or more written into the labor contract, which runs through March 2014.

Melissa Bova, government affairs representative for the Pennsylvania Restaurant and Lodging Association in Harrisburg, said she wasn't so sure that automatic tipping was on the ropes.

"I don't know if it's going to change a lot," she said.

Not only does the practice help ensure that servers get a decent tip, she said, reclassifying automatic gratuities as wages is one way to ensure that more tip income is reported.

"It protects the business [by making sure] taxes are being remitted properly," she said.

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