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CONFIDENTIAL ATTORNEY-CLIENT PRIVILEGED MEMORANDUM

DATE: January 2, 2014

TO: Hotel Association of New York City, Inc.
Labor Relations Members
General Managers, Controllers and Human Resources Directors

FROM: Kane Kessler, P.C.
Labor and Employment Law Department

RE: IRS Ruling – Non-Discretionary Service Charges and/or Automatic Gratuities are Non-Tip Wages Subject to Withholding

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As a general rule, employers are not required to withhold taxes on tips that are not reported by the employee. However, pursuant to a recent Internal Revenue Service ("IRS") ruling, effective January 1, 2014, non-discretionary service charges and/or automatic gratuities added to a bill or fixed by an employer that the customer must pay and which are paid to an employee, will no longer constitute a "tip" but will rather constitute non-tip wages that are subject to applicable withholdings. It is now the employer's responsibility to monitor and withhold taxes on these automatic payments, even if they are not reported as "tips" by the employee.

According to the IRS ruling, a tip is narrowly defined as: (i) an amount of money presented by a guest free from compulsion; (ii) a payment that the customer has the unrestricted right to determine the amount of; (iii) a payment whose amount cannot be the subject of negotiation or dictated by employer policy; and (iv) generally, a payment in which the customer can dictate and determine the recipient. If any of these four factors is absent, the automatic or non-discretionary service charge is not a tip and if any portion of the charge is distributed to an employee, it is considered wages for FICA tax purposes.

These factors must be examined with respect to all non-discretionary, automatic gratuities or service charges that are distributed to employees. Some of the types of charges that will be affected are:

- Automatic restaurant "gratuities" for parties;

- Automatic “gratuities” or service charges on room service checks;
- Service charges in connection with certain spa services

With respect to the tax implications of this ruling, we advise employers to consult with their tax counsel or accountants.

Apart from the tax implications, however, this ruling also has wage and hour consequences. Under both federal and state law, employees who are not exempt from overtime are entitled to overtime at the rate of 1 ½ of their regular hourly rate for all hours worked in excess of forty (40) in a workweek. Voluntary gratuities are not considered part of an employee’s regular rate of pay for the purpose of calculating the overtime rate. However, because federal and state law require that all wages be considered in calculating overtime, since all mandatory service charges will now be considered wages, they must therefore be part of the calculation for determining the regular rate of pay for overtime purposes. For example:

A restaurant worker makes $10 per hour. Without any automatic gratuities or service charges, his/her overtime rate would be $15 per hour.

The same worker makes $80 in “automatic” gratuities in a workweek. For that week, his/her overtime rate would be calculated by adding all of his/her wages and dividing by the number of hours worked in that workweek. If the employee worked 44 hours that week, his/her overtime rate would be calculated as follows:

$10 x 44 = $440 + 80 = $520 divided by 44 = $11.82 (regular rate) x 1 ½ = $17.73 (overtime rate).

Please note that the requirement to calculate the overtime rate using all wages earned in a workweek applies only to statutory overtime – that is, all hours worked in excess of 40 in a workweek. Under the IWA, overtime is paid for all hours over 7 or 8 in a workday or on the 6th and 7th day of work, but unless these hours exceed 40 in the workweek, the automatic gratuities need not be included in the overtime rate for these hours. We recognize, however, that calculating different overtime rates in a single workweek will be an administrative and payroll challenge.

As a result of the IRS ruling and its impact on overtime, we recommend that employers consider converting “automatic” gratuities into “suggested” gratuities so that the customer has a legitimate right to tip any amount or no amount. In such event, gratuities will not be considered wages subject to either withholdings nor to inclusion in weekly wages for overtime purposes. Hotels are advised to check whether they have hotel-specific agreements and/or practices which require the imposition of “automatic” gratuities. Where such agreement or practices exist, Hotels should consult with Association Labor Relations Counsel accordingly. In addition, we recommend that employers take steps to reduce or avoid overtime whenever possible. Under the IWA and Impartial Chairperson decisions, Hotels have the right to manage their staffing and schedules in order to avoid overtime or other premium pay.

If you have any questions, please do not hesitate to contact David R. Rothfeld, Judith A. Stoll, Lois M. Traub, Niki J. Franzitta, Alexander Soric or Robert L. Sacks.

cc: Joseph E. Spinnato, Esq.
Geoffrey A. Mills, Chairman