DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
Washington, D.C. 20224

June 7, 2012

Control No: SBSE-04-0612-057
Expires: June 7, 2013
Impacted IRM: 4.23.7

MEMORANDUM FOR ALL FIELD EXAMINATION OPERATIONS

FROM: Shenita Hicks /s/ **Shenita Hicks**
Director, Examination, SB/SE

John H. Imhoff Jr. /s/ **John H. Imhoff Jr.**
Director, Specialty Programs, SB/SE

David Horton /s/ **David Horton**
Director, Field Specialists, LB&I

Clifford J. Gannett /s/ **Clifford J. Gannett**
Acting Director, Government Entities, TE/GE

SUBJECT: Interim Guidance on Tips vs. Service Charges
Revenue Ruling 2012-18

The purpose of this memorandum is to provide administrative guidelines to examiners auditing a business where tipping is customary and/or where a business adds service charges to customers' bills which are then distributed to employees. This document is not intended to be a technical position, but to provide audit issue direction to examiners in dealing with these issues.

An employer's characterization of a payment as a "tip" is not determinative. When performing a tip examination, examiners must ensure that distributed service charges are properly characterized as wages and not tips.[1] Recently issued Rev. Rul. 2012-18, published in the 2012-26 Internal Revenue Bulletin, sets forth updated guidance on

[1] Distributed service charges that have been characterized as tips should generally be recharacterized and an adjustment made to the Form 941 under examination via employment tax report Form(s) 4666 and 4668. Service charges are not eligible for the credit claimed on Form 8846, and are not eligible for the General Business Credit claimed on Form 3800. When calculating the amount of unreported tips for an employer-only assessment under section 3121(q) of the Internal Revenue Code, examiners must ensure they do not include service charges in the Section 3121(q) Notice and Demand.

FICA taxes on tips.[2] Specifically, Q&A 1 of Rev. Rul. 2012-18 reaffirms the factors which are used to determine whether payments constitute tips or service charges found in Rev. Rul. 59-252, 1952 C.B. 215. Q&A 1 of Rev. Rul. 2012-18 provides that the absence of any of the following factors creates a doubt as to whether a payment is a tip and indicates that the payment may be a service charge:

(1) The payment must be made free from compulsion;
(2) The customer must have the unrestricted right to determine the amount;
(3) The payment should not be the subject of negotiation or dictated by employer policy; and,
(4) Generally, the customer has the right to determine who receives the payment.

Rev. Rul. 2012-18 also provides specific examples of amounts characterized as tips and service charges to illustrate the application of these factors.[3] Example A in Q&A 1 of Rev. Rul. 2012-18 illustrates a service charge paid by a large party when the menu specifies that a fixed charge will be added to all bills for parties of 6 or more customers and Example B illustrates a tip when the charge receipt shows sample tip calculations.

Rev. Rul. 2012-18 is effective immediately and applicable retroactively. However, under very limited facts and circumstances (specified below) with regard to amounts paid before January 1, 2013, that were improperly characterized as tips when they properly should have been characterized as service charges, an examiner should apply Q&A 1 of this revenue ruling prospectively, *i.e*., only to amounts paid on or after January 1, 2013. To the extent that Q&A 1 of this revenue ruling is applied without retroactive effect, an employer will not be required to pay any additional taxes. Employers that correctly treated service charges as wages are not entitled to a refund of any taxes they may have paid or will pay due to their proper reporting of service charges as wages.

In determining whether Q&A 1 of this revenue ruling should be applied prospectively, examiners should consider whether the set of facts and circumstances at issue was directly addressed in prior guidance and whether the business needs additional time to amend its business practices and make system changes to come into compliance. Some of the prior guidance which may be applicable includes Rev. Rul. 57-397, 1957-2 C.B. 628 (where amounts required to be paid to a hotel by customers for using dining facilities included amounts distributed by the hotel to waiters and other employees); Rev. Rul. 59-252 (where negotiations between a hotel and customer for use of hotel's banquet facilities included additional amounts for distribution to employees); Rev. Rul. 64-40, 1964-1 C.B. 68 (where a club's board of governors determined amounts

[2] Among the topics covered in this revenue ruling are reporting and depositing of FICA taxes on tips, Section 3121(q) Notice and Demand issues, and the section 45B credit.

[3] Other examples of amounts which should generally be characterized as service charges when any of the factors outlined in Q&A 1 of Rev. Rul. 2012-18 are absent include amounts paid by a customer for catering, banquets, weddings, transportation, and baggage handling and other amounts (frequently referred to by the service industry as "auto-gratuities") that are dictated by the policy of the employer.

distributed to employees from a fund made up of contributions by club members); Rev. Rul. 66-74, 1966-1 C.B. 229 (where amounts collected by a club through mandatory charges added to members' bills were distributed to employees); and Rev. Rul. 69-28, 1969-1 C.B. 270 (where five examples of amounts paid to employees are discussed). If examiners find that the set of facts and circumstances at issue was not directly addressed in prior guidance, then Q&A 1 of Rev. Rul. 2012-18 should be applied prospectively. In this regard, Q&A 1 should be applied prospectively to amounts paid under facts that are substantially the same as Example A.

When performing a tip rate review, examiners must ensure that distributed service charges are properly characterized as wages and not tips. Service charges should not be included in any calculation that arrives at an hourly tip rate, a tip rate calculated on a percentage of sales, or any other rate determination method. Examiners should note in their work papers and appendices that service charges were not included in the tip rate computations and how the employer should account for service charges.

In the past, due to automated or manual taxpayer business systems which failed to accurately classify payments, IRS examiners may have treated service charges as tip income for purposes of computing unreported tips or tip rates for voluntary tip compliance agreements. Note that existing agreements are not voided as a result of this memorandum. Examiners may contact establishments possessing an agreement to conduct a tip rate review to consider the tips vs. service charges issue. This will not constitute a "tip examination" within the meaning of an agreement. If distributed service charges were treated as tips, the agreement will be modified.

An examiner who encounters business practices which are unfamiliar or makes an initial determination that Rev. Rul. 2012-18 does not apply retroactively to a particular set of facts and circumstances should discuss the issue with Idolina Volz, SBSE National Tip Reporting Compliance Program, Senior Policy Analyst. Any questions by examiners regarding this memo should also be addressed to Ms. Volz.

cc: www.IRS.gov