



Employer Reminder: Reporting Tips versus Service Charges; Key Differences Between Categories Affect Employees, Tax Reporting

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The Internal Revenue Service reminds employers that so-called “automatic gratuities” and any amount imposed on the customer by the employer are service charges, not tips.

Service charges are generally wages, and they are reported to the employee and the IRS in a manner similar to other wages. On the other hand, special rules apply to both employers and employees for reporting tips. Employers should make sure they know the difference and how they report each to the IRS.

What are tips?

Tips are discretionary (optional or extra) payments determined by a customer that employees receive from customers.

Tips include:

- Cash tips received directly from customers.
- Tips from customers who leave a tip through electronic settlement or payment. This includes a credit card, debit card, gift card, or any other electronic payment method.
- The value of any noncash tips, such as tickets, or other items of value.
- Tip amounts received from other employees paid out through tip pools or tip splitting, or other formal or informal tip sharing arrangements.

Four factors are used to determine whether a payment qualifies as a tip. Normally, all four must apply. To be a tip:

- 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 negotiations or dictated by employer policy; and
- Generally, the customer has the right to determine who receives the payment.

If any one of these doesn't apply, the payment is likely a service charge.

What are service charges?

Amounts an employer requires a customer to pay are service charges. This is true even if the employer or employee calls the payment a tip or gratuity.

Examples of service charges commonly added to a customer's check include:

- Large dining party automatic gratuity
- Banquet event fee
- Cruise trip package fee
- Hotel room service charge
- Bottle service charge (nightclubs, restaurants)

Generally, service charges are reported as non-tip wages paid to the employee. Some employers keep a portion of the service charges. Only the amounts distributed to employees are non-tip wages to those employees.

Reporting Tips and Directly and Indirectly Tipped Employees

Employees must report to their employer all cash tips received -- except for the tips from any month that total less than \$20:

- **Cash tips** include tips received from customers, charged tips (for example, credit and debit card charges) distributed to the employee by his or her employer, and tips received from other employees under any tip-sharing arrangement.
- **Noncash tips** (that is, tips received by an employee in any other medium than cash, such as passes, tickets, or other goods or commodities) from customers are not reported to the employer.

All cash tips and noncash tips should be included in an employee's gross income and subject to federal income taxes.

Both directly and indirectly tipped employees must report tips to their employer.

A "directly tipped employee" is any employee who receives tips directly from customers, including one who, after receiving the tips, turns all of them over to a tip pool. Examples of directly tipped employees are waiters, waitresses, bartenders and hairstylists.

An "indirectly tipped employee" is a tipped employee who does not normally receive tips directly from customers. Examples of indirectly tipped employees are bussers, service bartenders, cooks and salon shampooers.

Employers are required to retain employee tip reports, withhold income taxes and the employee share of Social Security and Medicare taxes from the wages paid, and withhold income taxes and the employee share of Social Security and Medicare taxes on reported tips from wages (other than tips) or from other funds provided by the employee. In addition, employers are required to pay the employer share of Social Security and Medicare taxes

based on the total wages paid to tipped employees as well as the reported tip income. Employers must report income tax and Social Security and Medicare taxes withheld from their employees' wages, along with the employer share of Social Security and Medicare taxes, on Form 941, Employer's Quarterly Federal Tax Return, and deposit these taxes in accordance with federal tax deposit requirements.

Tips reported to the employer by the employee must be included in Box 1 (Wages, tips, other compensation), Box 5 (Medicare wages and tips), and Box 7 (Social Security tips) of the employee's Form W-2, Wage and Tax Statement. Enter the amount of any uncollected social security tax and Medicare tax in Box 12 of Form W-2. See the General Instructions for Forms W-2 and W-3.

For more information, including what to do if there are not enough wages to withhold all of the taxes, see Topic 761 - Tips – Withholding and Reporting.

Reporting Service Charges

Employers who distribute service charges to employees should treat them the same as regular wages for tax withholding and filing requirements, as provided in Publication 15, Employer's Tax Guide.

Distributed service charges must be included in Box 1 (Wages, tips, other compensation), Box 3 (Social Security wages), and Box 5 (Medicare wages and tips) of the employee's Form W-2.

Online Help Available

- Let Us Help You
- IRS Tip Program - Tip.Program@irs.gov
- Publication 531, Reporting Tip Income: This publication is for employees who receive tips.
- Publication 1244, Employee's Daily Record of Tips and Report to Employer
- Publication 15, Employer's Tax Guide
- Revenue Ruling 2012-18

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