



AUTOMATIC GRATUITY & SERVICE CHARGES

A Compliance FAQ for Independent Restaurants & Bars

With the FIFA World Cup coming to the United States, many restaurants are exploring automatic gratuities as a practical tool for serving international guests who may be unfamiliar with American tipping culture. It is a sound strategy — but it carries compliance obligations that are frequently misunderstood.

The core issue: an automatic gratuity is not a tip under federal law. It is a service charge, and it is treated as wages. That single distinction has cascading consequences for how you run payroll, calculate overtime, report taxes, and claim credits.

This FAQ is designed to give restaurant operators a clear, plain-language understanding of those obligations, grounded in guidance from the IRS and the U.S. Department of Labor's Wage and Hour Division (WHD).

Characteristic	Tip (Voluntary)	Auto Gratuity (Service Charge)
Set by customer?	Yes	No — employer sets the amount
Classified as	Tip income	Wage / non-tip income
Payroll withholding	Reported separately (Form 4070)	Full payroll taxes withheld
Tip credit eligible?	Yes (FLSA §3(m)(2)(A))	No
FICA Tip Credit (§45B) eligible?	Yes	No
Counts toward overtime rate?	No	Yes — included in regular rate
W-2 reporting	Box 7 (Social Security Tips)	Box 1 (Wages)
Employer controls distribution?	No (except tip pools)	Yes — employer decides
Back-of-house sharing allowed?	Not when tip credit is taken.	Yes — employer may distribute freely
Sales Tax impacted?	No	Maybe, state-specific



Tips vs. Service Charges

Q. What is the legal difference between a tip and an automatic gratuity?

Under IRS Revenue Ruling 2012-18, a payment qualifies as a tip only if all four of the following conditions are met:

- The payment is made free from compulsion
- The customer has the unrestricted right to determine the amount
- The payment is not the subject of negotiation or dictated by employer policy
- Generally, the customer has the right to determine who receives the payment

An automatic gratuity fails the first two tests immediately. Because the restaurant sets the amount and adds it to the bill, the customer has no discretion. The IRS therefore classifies it as a service charge — and service charges are treated as regular wages, not tip income.

Q. Does it matter if we label the charge as gratuity, service charge or auto-grat on the check?

No. The IRS is explicit: an employer's or employee's characterization of a payment as a 'tip' is not determinative. What matters is the nature of the payment. If the amount is mandatory and set by the restaurant, it is a service charge regardless of the label used on the receipt or in your POS system.

This means labeling it 'gratuity' on the guest check does not change its tax or wage classification — and using that label incorrectly can itself create compliance exposure. This is also true for WHD compliance.

Payroll, Wages & Tax Reporting

Q. How does the IRS require us to report service charges paid to employees?

Service charges distributed to employees must be:

- Processed through payroll as regular wages (not as tip income)
- Subject to full federal income tax withholding
- Subject to both the employee and employer share of FICA taxes (Social Security and Medicare)
- Reported on the employee's W-2 in Box 1 (Wages), not Box 7 (Social Security Tips)
- Reported quarterly by the employer on IRS Form 941

Your POS and payroll systems must be configured to distinguish service charges from tips. Commingling these two categories in your records is one of the most common audit triggers.

Q. We currently use the tip credit to pay servers. Does auto gratuity affect our ability to use the tipped minimum wage?

Yes — significantly. Under the FLSA, an employer may only take a tip credit (paying tipped employees as little as \$2.13/hour federally) when employees are actually receiving tips.



Because service charges are wages, not tips, they cannot be counted as tip income for purposes of the tip credit.

This means: if a server works a shift where all of the revenue they receive is from service charges (no voluntary tips), the employer cannot claim a tip credit for those hours and must pay the full applicable minimum wage as direct cash wages.

Practically, for a World Cup period where some shifts may be predominantly large-party, auto-grat tables, restaurants need to carefully track tip-credit eligibility shift by shift.

Q. Do we lose the FICA Tip Credit when we use auto gratuity?

Yes — for the service charge portion. The FICA Tip Credit under IRC Section 45B allows restaurant employers to claim a dollar-for-dollar credit equal to their share of FICA taxes paid on employee tip income above the minimum wage. It is one of the most valuable tax benefits available to restaurants.

However, the IRS is explicit: distributed service charges and auto-gratuities are characterized as non-tip wages and are excluded from the FICA Tip Credit. Because service charges are treated as ordinary wages, the employer's FICA obligation on those amounts is simply a cost — not eligible for the 45B credit.

This makes auto gratuity more expensive from a tax standpoint than the equivalent revenue received as voluntary tips. Operators should weigh this cost when deciding how broadly to implement the policy.

Q. I have sales tax in my state. Is that impacted?

Maybe — generally speaking, service charges are considered restaurant revenue, and part of sales. But, some states have exceptions to what this means for sales tax, so please check local regulations to ensure you're in compliance.

Overtime Calculations

Q. How does a service charge impact overtime calculations and why is it more complex than for tips?

This is where the compliance risk is highest and least understood.

Under the FLSA, overtime is calculated at 1.5x the employee's regular rate of pay. If an employer pays tipped employees at least \$2.13 per hour, but less than the federal minimum wage required, and is using the tips the employees receive to meet the federal minimum wage requirement (tip credit), then the tips received in excess of those applied to meet the federal minimum wage are excluded from the regular rate calculation. If an employer pays tipped employees at least the federal minimum wage, the tips are also excluded from the regular rate calculation. However, if an employer requires service charges and provides any part of those service charges to their employees, those service charges must be included in the regular rate calculation.



Service charges are wages and must be factored into the regular rate of pay used to compute overtime. This means a server who earns service charges in a workweek where they also work overtime can have a higher regular rate of pay — and therefore a higher overtime rate — than a server who only receives tips.

The formula for regular rate of pay when service charges are involved:

1. Add together: direct cash wages paid + service charges distributed = total straight-time compensation (which must equal at least the federal minimum wage (currently \$7.25 per hour))
2. Divide by total hours worked in the workweek
3. That result is the regular rate
4. Overtime premium = $0.5 \times \text{regular rate} \times \text{overtime hours}$

Q. Can you show us three side-by-side calculations: tips only, service charges only and tipped minimum wage with a service charge?

Yes. In each scenario below, assume a server works 45 hours in a workweek (5 hours of overtime). The federal tipped minimum wage direct cash wage is \$2.13/hour; the federal full minimum wage is \$7.25/hour. Federal figures are used for illustration — your state may be higher.

Scenario 1: Tipped Minimum Wage + Voluntary Tips Only (No Service Charge)

Item	Amount
Hours Worked	45
Regular cash wage (40 hrs × \$2.13)	\$85.20
Tips received (voluntary)	\$315.00
OT Rate of Pay (\$7.25 × 1.5 - \$5.12 tip credit)	\$5.76
Overtime cash wage (5 hrs × \$5.76)	\$28.80
Total required pay for week	\$429 (approx.)
Minimum wage check (45 hrs × \$7.25 = \$326.25)	✓ Satisfied (\$429 > \$326.25)

Key point: Tips do not inflate the regular rate of pay. Overtime is calculated cleanly off the minimum wage floor.

**Scenario 2: Service Charge Only (No Voluntary Tips — Full Minimum Wage Required)**

Item	Amount
Direct cash wage (45 hrs × \$7.25 — no tip credit)	\$326.25
Service charge distributed to server	\$315.00
Total straight-time compensation	\$641.25
Regular rate of pay (\$641.25 ÷ 45 hrs)	\$14.25/hr
Overtime premium (0.5 × \$14.25 × 5 hrs)	\$35.63
Total pay for week	\$676.88 (approx.)

Key points: (1) No tip credit — full \$7.25/hr direct wage required. (2) Service charge is included in regular rate calculation, significantly increasing overtime cost.

Scenario 3: Mixed Week — Tipped Minimum Wage + Service Charge + Voluntary Tips

Item	Amount
Hours Worked	45
Regular cash wage (40 hrs × \$2.13)	\$85.20
Tips received (voluntary)	\$200
Service charge distributed	\$115
OT Rate of Pay (\$7.25 × 1.5 - \$5.12 tip credit)	\$5.76
Additional hourly OT from service charge (\$115/45 hours)	\$2.56
Total OT rate of pay (\$5.76 + \$2.56)	\$8.32
Overtime cash wage (5 hrs × \$8.32)	\$41.58
Total pay for week	\$441.78 (approx.)
Total pay excluding service charges (\$441.78 - \$115)	\$325.78
Minimum wage check (45 hrs × \$7.25 = \$326.25)	✓ Satisfied (\$326.78 > \$326.25)



Key points: Voluntary tips are still excluded from the regular rate. Only the service charge is added to cash wages when computing the overtime base. This is the most common scenario for World Cup-period operations.

Employee Distribution & Back-of-House

Q. Can we use service charges to compensate the back of house?

Yes. Under the FLSA, service charges, are the restaurant's revenue — not the customer's. The employer controls how they are distributed. This means restaurants may legally direct service charge revenue to back-of-house staff, kitchen teams, or any combination of employees, without violating FLSA tip pool rules.

This flexibility makes auto gratuity an attractive tool for operators looking to boost back-of-house compensation during high-demand periods.

Under the FLSA's tip pooling rules, voluntary tips can only be shared with employees who 'customarily and regularly' receive tips (e.g., servers, bartenders, bussers) if the employer avails itself in using the 3(m) Tip Credit. Cooks and dishwashers are generally excluded from tip pools. It is important to note that under no circumstances may a manager receive funds from a tip pool.

Q. Are there any state-level restrictions on service charge distribution

Yes. While federal law gives employers broad discretion over service charge distribution, many states have enacted stricter rules. Some states require that mandatory service charges be distributed to the employees who served the table, or mandate disclosure to employees and guests.

Always layer your state and local law review on top of federal guidance. The DOL's Wage and Hour Division can only speak to federal requirements; for state-specific rules, consult your state labor agency or legal counsel.

Implementation & Disclosure

Q. Do I need to communicate this to my employees?

In the same way employers are required to submit a [notice to tipped employees](#), they must also ensure employees who are receiving distributed auto-gratuities/service charges are informed. For recordkeeping, it's best to have signed documentation of acceptance.

Q. What are the disclosure obligations to guests when adding an automatic gratuity?

At a minimum, restaurants should clearly disclose the automatic service charge before or at the point of ordering — not just on the final check. Best practices include:



- Menu notation (e.g., 'An 18% service charge will be added to parties of 6 or more')
- Verbal disclosure by the server at table
- Clear line-item on the check distinct from the food and beverage total
- POS receipts that label it as 'Service Charge' — not 'Gratuity' or 'Tip' — to match its legal classification

Some states and municipalities have additional requirements.

Going Back to Voluntary Tips — Transitioning Out

Q. If we implement auto gratuity temporarily and then stop, what should we take into consideration?

Reverting to voluntary tips is straightforward operationally, but requires careful payroll housekeeping:

- Update your POS system to stop applying the service charge on the cutoff date
- Notify your payroll provider of the transition date so compensation is reclassified correctly going forward
- Ensure W-2 year-end reporting correctly reflects which weeks involved service charge wages vs. tip income
- Re-enable tip credit calculations for tipped employees beginning the pay period after the policy ends
- Review any overtime calculations during the transition weeks to ensure the rate used was correct for each type of pay

If you ran any pay periods that crossed the implementation or cutoff dates (part tip, part service charge), work with your payroll provider to correctly compute the blended regular rate for overtime purposes.

This FAQ is provided for general educational purposes and does not constitute legal or tax advice.



World Cup City Specific Information provided by EisenAmper

City	State	Tip Credit Allowed?	Surcharges Taxable?	Special Rules / Notes
Atlanta	GA	Yes	Yes	Mandatory charges taxable
Boston	MA	Yes (modified)	Yes	Mandatory charges taxable
Dallas	TX	Yes	Yes	TX: Mandatory gratuity ≤20% not taxable; >20% fully taxable
Houston	TX	Yes	Yes	TX: Mandatory gratuity ≤20% not taxable; >20% fully taxable
Kansas City	MO	Yes	Yes	Mandatory charges taxable
Los Angeles	CA	No	Yes	CA: Mandatory service charges taxable
Miami	FL	Yes	Yes	Mandatory charges taxable
New York / New Jersey	NY/NJ	Yes (complex)	Yes	Mandatory charges taxable
Philadelphia	PA	Yes	Yes	Mandatory charges taxable
San Francisco / Bay Area	CA	No	Yes	CA: Mandatory service charges taxable
Seattle	WA	No	Yes	WA: Prepared food & mandatory charges taxable

City	State	State OT Rules Beyond FLSA?	For OBBB calculations
Atlanta	GA	No	FLSA only
Boston	MA	No	FLSA only
Dallas	TX	No	FLSA only
Houston	TX	No	FLSA only
Kansas City	MO	No	FLSA only
Los Angeles	CA	Yes	Daily OT; double time; but FLSA regular rate still governs surcharge inclusion
San Francisco	CA	Yes	Same as above
Seattle	WA	No	FLSA only; local service-charge rules
Miami	FL	No	FLSA only
Philadelphia	PA	No	FLSA only
New York / New Jersey	NY/NJ	No	FLSA only; local disclosure rules