STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

September 24, 1965

Gentlemen:

This is with reference to the petition for redetermination of tax filed on behalf of the "P" country club and the preliminary hearing held on the question of "service charges" last August 19th.

We have reviewed the question in light of the contentions made in the petition for redetermination, the case of Anders v. State Board of Equalization, 82 Cal. App. 2d 88, Attorney General Opinion NS 3297 (2/25/41), various tax counsel opinions cited in both CCH and Cal. Tax Service, and Cal. Adm. Code subsection 2003(d) (Ruling 53).

Ruling 53 provides, in part, that amounts designated as service charges, added to the price of meals, are a part of the selling price of the meals and accordingly must be included in the retailer's gross receipts subject to tax even though such service charges are made in lieu of tips and are paid over by the retailer to the employees.

This rule has not been administered as strictly as it reads, inasmuch as the test for exemption does not turn solely on whether a sum is called a “tip” or whether it is called a “service charge”, but rather (1) whether the sum is a gratuity or an exaction, and (2) if it is a gratuity, whether it is used by the employer to offset wages agreed to be paid or required to be paid under minimum wage laws.

If the sums are obtained by exaction, they are taxable gross receipts regardless of whether they are used to offset wages agreed to be paid.

It is our opinion that the Attorney General Opinion does not provide for the rule that “the test is not how the tips are paid but who has the legal right to tips when paid.”

The fact that the employees may have a legal right to the service charges does not necessarily make them gratuities. On the basis that "P" has a rule (and the members agree to abide by the rules) the club has a legal right to collect the service charges, and to this extent they cannot be gratuities.

The reason for adopting the rule may have been benevolence, but once it became a rule (or club policy) it became an obligation of the member. The assessment is automatic, standard and inflexible. Thus, we disagree with the contention that because the members have agreed to the service charge (or have acquiesced in it) that it amounts to a gratuity.

The Attorney General Opinion cited above holds, among other things, that service charges added to the price of a meal and paid to the waiter for the services in connection with the sale are taxable gross receipts, and "to conclude otherwise would also be to conclude that whenever a

retailer wished to avoid a tax on the portion of his gross receipts which he proposed to pay his employees, all he need do would be to make a separate charge for services."

We do not think the question of who has a legal right to the money is paramount. An employee could have a legal right to money he has been given personally by a customer and the money could well be a gratuity for services. This raises the point in the Anders case cited above. That case stands for the rule that if the employer uses the tips, gratuitously received by an employee from a customer, to offset minimum wage requirements, or even any wage agreed to be paid, the gratuity becomes taxable gross receipts of the employer-retailer.

In the "P" matter we are not concerned with the question of how the money is handled or accounted, but whether it was a gratuity or an exaction when paid. If it were concluded to be a gratuity we would then look to see whether it was used to offset wages.

Reference was made to two tax counsel opinions regarding tips and cited in both CCH and Cal. Tax Service.

The first one, under a date of August 28, 1953, provides:

> Where a restaurant operator merely collects the tips on behalf of the employee and does not apply them against the employees' minimum wages, under circumstances where the customer is not obligated to pay the tip, the amount of such tip is not part of the retailer's gross receipts from the sale of meals. (Emphasis added.)

This is exactly the credit card situation which we do not find to be the case in "P". The distinction is that "P" members are obligated (by reason of the club rule) to pay the service charge. The reason behind adopting the rule is immaterial.

If in a credit card charge system, a fixed percent was automatically added and was ultimately given to the waiter, it would not be a gratuity even though the holder of the card agreed to such a charge as a condition to using the credit card.

In the "P" charge plan, if with each meal check the member was given the option of having the club add a service charge or being charged only for the meal without a service charge, then the service charge (or whatever it might be called) would clearly be a gratuity. However, if the amount so charged was used by the club to offset wages agreed to be paid to the employee, the amount would be taxable gross receipts as in the Anders case.

The second tax counsel opinion under the date of December 21, 1954 provides for a 4-point test where, under a lump-sum charge for meals, a part of the sum is for a tip. In order to be exempt, all 4 tests must be met. The third test requires that: "The amount of the tip, even though separately stated, is not determined by a virtually inflexible rule or policy of the retailer." (Emphasis added.)

We are of the opinion that the rule adopted by "P" is virtually inflexible. Every member is charged 15 percent. The policy is fixed, the charge is automatic, and the amount is standard.

From the foregoing it is concluded that the "service charges", even though paid over to the employees, and even though not used to offset wages, are taxable gross receipts since they are

collected as exactions and not gratuities. Thus, we are not recommending any adjustment.

If your client wishes to have the matter heard before the Board, please let us know within three weeks.

Very truly yours,

Robert H. Anderson
Associate Tax Counsel

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