



STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0092
1-916-324-1825 • FAX 1-916-322-4530
www.boe.ca.gov

BETTY T. YEE
First District, San Francisco

SEN. GEORGE RUNNER (Ret.)
Second District, Lancaster

MICHELLE STEEL
Third District, Orange County

JEROME E. HORTON
Fourth District, Los Angeles

JOHN CHIANG
State Controller

CYNTHIA BRIDGES
Executive Director

November 22, 2013

Dear Interested Party:

Enclosed is the Initial Discussion Paper on whether to amend Regulation 1603, *Taxable Sales of Food Products*, to clarify the application of tax to mandatory tips, gratuities, and service charges. Before the issue is presented at the Board's May 22, 2014 Business Taxes Committee meeting, staff would like to invite you to discuss the issue and present any additional suggestions or comments. Accordingly, an interested parties meeting is scheduled as follows:

December 10, 2013
Room 121 at 10:00 a.m.
450 N Street, Sacramento, CA

If you would like to participate by teleconference, call 1-888-636-3807 and enter access code 499201. You are also welcome to submit your comments to me at the address or fax number in this letterhead or via email at Susanne.Buehler@boe.ca.gov by January 10, 2014. Copies of the materials you submit may be provided to other interested parties, therefore, ensure your comments do not contain confidential information. Please feel free to publish this information on your website or distribute it to others that may be interested in attending the meeting or presenting their comments.

If you are interested in other Business Taxes Committee topics refer to our webpage at (<http://www.boe.ca.gov/meetings/btcommittee.htm>) for copies of discussion or issue papers, minutes, a procedures manual, and calendars arranged according to subject matter and by month.

Thank you for your consideration. We look forward to your comments and suggestions. Should you have any questions, please feel free to contact our Business Taxes Committee staff member Mr. Robert Wilke at 1-916-445-2137, who will be leading the meeting.

Sincerely,

A handwritten signature in cursive script that reads "Susanne Buehler".

Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department

Enclosures

cc: (all with enclosures)

Honorable Jerome E. Horton, Chairman, Fourth District
Honorable Michelle Steel, Vice Chair, Third District
Honorable Betty T. Yee, Member, First District (MIC:71)
Senator George Runner (Ret.), Member, Second District (via email)
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(via email)

Mr. David Hunter, Board Member's Office, Fourth District
Mr. Michael Vigil, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichelt, Board Member's Office, Third District
Mr. Alan LoFaso, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Sean Wallentine, Board Member's Office, Second District
Mr. James Kuhl, Board Member's Office, Second District
Mr. Lee Williams, Board Member's Office, Second District
Mr. Alan Giorgi, Board Member's Office, Second District
Ms. Lynne Kinst, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Cynthia Bridges (MIC:73)
Mr. Randy Ferris (MIC:83)
Mr. Jeffrey L. McGuire (MIC:43)
Mr. Jeff Vest (MIC:85)
Mr. Jeff Angeja (MIC:85)
Mr. David Levine (MIC:85)
Mr. Robert Tucker (MIC:82)
Mr. Bradley Heller (MIC:82)
Mr. Lawrence Mendel (MIC:82)
Mr. Cary Huxsoll (MIC:82)
Mr. Todd Gilman (MIC:70)
Ms. Lauren Simpson (MIC:70)
Mr. Joe Fitz (MIC:67)
Mr. Bill Benson (MIC:67)
Mr. Wayne Mashihara (MIC:46)
Mr. Kevin Hanks (MIC:49)
Mr. Bradley Miller (MIC:92)
Ms. Kirsten Stark (MIC:50)
Mr. Clifford Oakes (MIC:50)
Mr. Michael Patno (MIC:50)
Mr. Robert Wilke (MIC:50)

INITIAL DISCUSSION PAPER
Regulation 1603, *Taxable Sales of Food Products*
Application of Tax to Tips, Gratuities, and Service Charges

Issue

Whether Regulation 1603, *Taxable Sales of Food Products*, should be amended to clarify the application of tax to tips, gratuities, and service charges.

General Legal Background/Current Administrative Practice

Sales tax is imposed on a retail sale of tangible personal property in the state, measured by the retailer's gross receipts, unless specifically exempt from taxation by statute. (Rev. & Tax. Code, § 6051.) While the sales tax is imposed upon the retailer for the privilege of selling tangible personal property at retail in California, the retailer may collect tax reimbursement from the customer if the contract of sale so provides. (Civ. Code, §1656.1; Cal. Code Regs., tit. 18, §1700, subd. (a)(1).) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (Rev. & Tax. Code, § 6091.)

The term "gross receipts" means the total amount of the sale without any deduction for the cost of materials used, labor or service costs, interest paid, losses, or any other expense. (Rev. & Tax. Code, §6012, subd. (a)(2).) Gross receipts also include any services that are part of the sale and all receipts, cash, credits and property of any kind. (Rev. & Tax. Code, § 6012, subd. (b)(1) & (2).)

Regulation 1603, *Taxable Sales of Food Products*

While sales of food products for human consumption are generally exempt from tax (Rev. & Tax. Code, § 6359, subd. (a)), this exemption does not apply to sales of meals or hot prepared food products furnished by restaurants and similar establishments whether served on or off the premises.

Regulation 1603 provides guidance to establishments that make taxable sales of food products. With respect to tips, gratuities, and service charges, subdivision (g) specifies that an optional payment designated as a tip, gratuity, or service charge is not subject to tax, but a mandatory payment designated as a tip, gratuity, or service charge is included in taxable gross receipts, even if the amount is subsequently paid by the retailer to the server.

Optional Payment

A tip, gratuity, or service charge is clearly optional if the customer adds the amount to the bill presented by the retailer, or otherwise leaves a separate amount in payment over and above the actual amount due the retailer for the sale of meals, food, and drinks and services related to those sales. The following examples illustrate transactions where a payment of a tip, gratuity or service charge is clearly optional: (1) the restaurant check is presented to the customer with the "tip" area blank so the customer may voluntarily write in an amount, or (2) the restaurant check is presented to the customer with options computed by the retailer and presented to the customer as tip suggestions, with the "tip" area blank so the customer may voluntarily write in an amount.

INITIAL DISCUSSION PAPER
Regulation 1603, Taxable Sales of Food Products
Application of Tax to Tips, Gratuities, and Service Charges

Labor Code

Pursuant to Labor Code section 351, no employer or agent shall collect, take, or receive any gratuity or a part thereof that is paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of a gratuity, or require an employee to credit the amount, or any part thereof, of a gratuity against and as a part of the wages due the employee from the employer. If this section is violated, any amount of the gratuities received by the employer is part of the employer's taxable gross receipts.

Mandatory Payment

An amount expressly negotiated between the retailer and the customer in advance of a meal, food, or drinks, or an event that includes a meal, food, or drinks is clearly mandatory. For example, when the retailer enters into contracts to cater banquets that specify that an amount for gratuities or service charges will be added, the amount automatically added by the retailer to the bill or invoice presented to and paid by the customer is clearly a mandatory charge.

Presumption that an Amount is a Mandatory Payment

Any amount added as a tip by the retailer to the bill or invoice presented to the customer is presumed to be a mandatory payment. The presumption may be overcome by documentary evidence showing that the customer specifically requested and authorized the gratuity be added to the amount billed. (Cal. Code Regs., tit. 18, § 1603, subd. (g)(2)(C).)

Examples of documentary evidence that may be used to overcome the presumption include: (1) a guest check that is presented to the customer showing sales tax reimbursement and the amount upon which it was computed, without tip or with the "tip" area blank and a separate document, such as a credit card receipt, to which the retailer adds or prints the requested tip; (2) guest receipts and payments showing that the percentage of tips paid by large groups varies from the percentage stated on the menu, brochure, advertisement or other printed materials; and (3) a retailer's written policy stating that its employees shall receive confirmation from a customer before adding a tip together with additional verifiable evidence that the policy has been enforced. (Cal. Code Regs., tit. 18, § 1603, subd. (g)(2)(C).)

Discussion

Voluntary tips are not intended for the owner of a restaurant, but are gratuities for the restaurant's employees. These gratuities are intended by the customers to augment the compensation paid to the employees by the employer, but there is no legal obligation for the customers to give these gratuities. An amount added to the bill by the customer for a gratuity is considered to be "optional." Under current law, a mandatory service charge made by the retailer in connection with its sale of tangible personal property is subject to tax if the sale of the property is subject to tax. The Board's policy has presumed a gratuity added to the bill by the retailer to be mandatory, even when a statement on the menu or bill indicates that the gratuity is optional.

INITIAL DISCUSSION PAPER

Regulation 1603, *Taxable Sales of Food Products* Application of Tax to Tips, Gratuities, and Service Charges

Although Regulation 1603 subdivision (g) was amended in 2007 to clarify the application of tax to tips, gratuities and service charges, it has become evident to staff that there remains confusion regarding what constitutes “mandatory” versus “optional” tips and gratuities.

Openness to Alternative Approaches to Current Administrative Practice

Staff is open to input on ways to clarify Regulation 1603 to provide better guidance for distinguishing between optional and mandatory tips and gratuities. For example, an approach consistent with current Internal Revenue Service guidelines may help reduce confusion, provide a more uniform approach for retailers, and provide a bright-line rule. On June 25, 2012, the IRS published the 2012-26 Internal Revenue Bulletin, which includes [Revenue Ruling 2012-18](#). The purpose of the revenue ruling was to clarify and update guidelines regarding taxes imposed on tips under the Federal Insurance Contributions Act, including information on the difference between tips and service charges (which are regarded as non-tip wages). The revenue ruling states that an employer’s characterization of payment as a “tip” is not determinative. The revenue ruling also reaffirms prior IRS guidance, which 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.

Aligning the mandatory tip provisions of Regulation 1603 so that they are consistent with IRS reporting requirements for tip wages may result in greater clarity regarding the application of tax to tips, gratuities, and service charges. This would allow easier compliance with both IRS and BOE reporting requirements. Staff would like to stress, however, that it is open to other suggestions for how to increase clarity and ease compliance with regard to this issue.

Sample Regulatory Amendments Applying the IRS Approach

For purposes of discussion, staff has drafted proposed regulatory amendments to Regulation 1603 that make a retailer’s reporting of these amounts under the Sales and Use Tax Law consistent with reporting such amounts to the IRS (See Exhibit 1). Staff offers this draft language as an example of a bright-line approach that eases compliance for retailers.

Prospective Basis for Amendments

Under Revenue and Taxation Code section 7051, “[t]he board may prescribe the extent to which any ruling or regulation shall be applied without retroactive effect.” In other words, when the Board wishes to limit the retroactive effect of a regulation, or amendments thereto, it is authorized to do so, and would accomplish it by taking affirmative action in the regulatory process by means of specifying an operative date for the amendments.

INITIAL DISCUSSION PAPER

Regulation 1603, *Taxable Sales of Food Products* Application of Tax to Tips, Gratuities, and Service Charges

Because of the general confusion staff perceives with respect to the records that must be kept to rebut the presumption of a mandatory charge (when applicable), staff recommends that any amendments to Regulation 1603 have a prospective application so that taxpayers and staff are notified well in advance of any record-keeping changes that may be expected.

Summary

Staff is interested in working with interested parties to develop a bright-line approach that will foster reporting compliance and audit efficiency with respect to tips, gratuities, and service charges. While staff has offered a possible approach for discussion purposes, staff is open to any other suggestions or options that might be presented by industry and representatives that would also serve to clarify the application of tax to these transactions, remove any ambiguity, and provide more certainty so that taxpayers can more easily understand their obligations under the Sales and Use Tax Law. Interested parties are welcome to submit comments or suggestions on the issues discussed in this paper, and are invited to participate in the interested parties meeting scheduled for December 10, 2013.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of November 21, 2013

Sales and Use Tax Regulation 1603. Taxable Sales of Food Products.

(For purposes of discussion and ease of reference, only the suggested amendments to this regulation have been provided. Other subdivisions have been omitted.)

(g) Tips, Gratuities, and Service Charges.

This subdivision applies to restaurants, hotels, caterers, boarding houses, soda fountains, drive-ins and similar establishments.

An optional payment designated as a tip, gratuity, or service charge is not subject to tax. A mandatory payment designated as a tip, gratuity, or service charge is included in taxable gross receipts, even if the amount is subsequently paid by the retailer to employees.

(1) Optional Payment.

(A) When a retailer keeps records consistent with reporting the tips as tip wages for IRS purposes, such amounts are presumed to be optional and not subject to tax.

~~A payment of a tip, gratuity, or service charge is optional if the customer adds the amount to the bill presented by the retailer, or otherwise leaves a separate amount in payment over and above the actual amount due the retailer for the sale of meals, food, and drinks that include services. The following examples illustrate transactions where a payment of a tip, gratuity or service charge is optional and not included in taxable gross receipts. This is true regardless of printed statements on menus, brochures, advertisements or other materials notifying customers that tips, gratuities, or service charges will or may be added by the retailer to the prices of meals, food, or drinks:~~

The following examples illustrate transactions where a payment of a tip, gratuity or service charge is optional and not included in taxable gross receipts:

Example 1. The restaurant check is presented to the customer with the "tip" area blank so the customer may voluntarily write in an amount, or

Example 2. The restaurant check is presented to the customer with options computed by the retailer and presented to the customer as tip suggestions. The "tip" area is blank so the customer may voluntarily write in an amount:

Guest Check

Food Item A	\$9.95
Beverage Item B	3.75
Subtotal	\$13.70
8% sales tax	1.10
Subtotal	\$14.80
Tip*	

Total

*Suggested tips:

15%=\$2.06; 18%=\$2.47; 20%=\$2.74; other.

Under these circumstances, the customer was free to enter any amount on the tip line or leave it blank; thus, the customer could enter an amount free from compulsion. The customer and restaurant did not negotiate the amount nor did the restaurant dictate the amount. The customer generally determined who would get the amount.

If an employer misappropriates these payments for these charges, as discussed in subdivision (g)(~~34~~)(~~B~~) below, such payments are included in the retailer's taxable gross receipts.

~~(B) No employer shall collect, take, or receive any gratuity or a part thereof, paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of such gratuity, or require an employee to credit the amount, or any part thereof, of such gratuity against and as a part of the wages due the employee from the employer. (Labor Code section 351.) If this prohibition is violated, any amount of such gratuities received by the employer will be considered a part of the gross receipts of the employer and subject to the tax.~~

(2) Mandatory Payment.

A payment of a tip, gratuity, or service charge is deemed to be mandatory if the amounts are required to be reported, for the purpose of income tax to the Internal Revenue Service, as non-tip wages. In general, this is required when any one of the following factors applies:

(A) The payment is not made free from compulsion;

(B) The customer does not have the unrestricted right to determine the amount;

(C) The payment is the subject of negotiation; or

(D) The payment is dictated by the retailer's policy, written or otherwise.

(3) No employer shall collect, take, or receive any gratuity or a part thereof, paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of such gratuity, or require an employee to credit the amount, or any part thereof, of such gratuity against and as a part of the wages due the employee from the employer. (Labor Code section 351.) If this prohibition is violated, any amount of such gratuities received by the employer will be considered a part of the gross receipts of the employer and subject to the tax.

~~(A) An amount negotiated between the retailer and the customer in advance of a meal, food, or drinks, or an event that includes a meal, food, or drinks is mandatory.~~

~~(B) When the menu, brochures, advertisements or other printed materials contain statements that notify customers that tips, gratuities, or service charges will or may be~~

~~added, an amount automatically added by the retailer to the bill or invoice presented to and paid by the customer is a mandatory charge and subject to tax. These amounts are considered negotiated in advance as specified in subdivision (g)(2)(A). Examples of printed statements include:~~

~~“An 18% gratuity [or service charge] will be added to parties of 8 or more.”~~

~~“Suggested gratuity 15%,” itemized on the invoice or bill by the restaurant, hotel, caterer, boarding house, soda fountain, drive-in or similar establishment.~~

~~“A 15% voluntary gratuity will be added for parties of 8 or more.”~~

~~An amount will be considered “automatically added” when the retailer adds the tip to the bill without first conferring with the customer after service of the meal and receiving approval to add the tip or without providing the customer with the option to write in the tip. Nonetheless, any amount added by the retailer is presumed to be mandatory. This presumption may be overcome as discussed in subdivision (g)(2)(C) below.~~

~~(C) It is presumed that an amount added as a tip by the retailer to the bill or invoice presented to the customer is mandatory. A statement on the bill or invoice that the amount added by the retailer is a “suggested tip,” “optional gratuity,” or that “the amount may be increased, decreased, or removed” by the customer does not change the mandatory nature of the charge.~~

~~This presumption may be controverted by documentary evidence showing that the customer specifically requested and authorized the gratuity be added to the amount billed.~~

~~Examples of documentary evidence that may be used to overcome the presumption include:~~

- ~~1. A guest check that is presented to the customer showing sales tax reimbursement and the amount upon which it was computed, without tip or with the “tip” area blank and a separate document, such as a credit card receipt, to which the retailer adds or prints the requested tip.~~
- ~~2. Guests receipts and payments showing that the percentage of tips paid by large groups varies from the percentage stated on the menu, brochure, advertisement or other printed materials.~~
- ~~3. A retailer's written policy stating that its employees shall receive confirmation from a customer before adding a tip together with additional verifiable evidence that the policy has been enforced. The policy is not in itself sufficient documentation to establish that the customer requested and authorized that a gratuity be added to the amount billed without such additional verifiable evidence.~~

~~The retailer must retain the guest checks and any additional separate documents to show that the payment is optional. The retailer is also required to maintain other records in accordance with the requirements of Regulation 1698, Records.~~