



STATE BOARD OF EQUALIZATION

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September 15, 2006

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State Controller, Sacramento

RAMON J. HIRSIG
Executive Director

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the September 27, 2006, Business Taxes Committee meeting. This meeting will address the proposed amendments to Regulation 1603, *Taxable Sales of Food Products*, regarding the application of tax to charges for mandatory and optional gratuities.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the "Business Taxes Committee" page on the Board's Internet web site (<http://www.boe.ca.gov/meetings/btcommittee.htm>) for copies of Committee discussion or issue papers, minutes, a procedures manual and calendars arranged according to subject matter and by month.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **9:30 a.m.** on **September 27, 2006** in Room 121 at the address shown above.

Sincerely,

Randie L. Henry, Deputy Director
Sales and Use Tax Department

RLH: caw

Enclosures

cc: (all with enclosures)
Honorable John Chiang, Chair
Honorable Claude Parrish, Vice Chairman
Ms. Betty T. Yee, Acting Member, First District (MIC 71)
Honorable Bill Leonard, Member, Second District (MIC 78)
Honorable Steve Westly, State Controller, C/O Ms. Marcy Jo Mandel (MIC 73)
Mr. Chris Schutz, Board Member's Office, Fourth District (MIC 72)



Mr. Neil Shah, Board Member's Office, Third District (via e-mail)
Mr. Romeo Vinzon, Member's Office, Third District (via e-mail)
Mr. Alan LoFaso, Board Member's Office, First District (via e-mail)
Mr. Steve Kamp, Board Member's Office, First District (MIC 71 and via e-mail)
Ms. Mira Tonis, Board Member's Office, First District (via e-mail)
Ms. Margaret Pennington, Board Member's Office, Second District (via e-mail)
Mr. Lee Williams, Board Member's Office, Second District (MIC 78 and via e-mail)
Mr. Ramon J. Hirsig (MIC 73)
Ms. Kristine Cazadd (MIC 83)
Mr. Robert Lambert (MIC 82)
Mr. Randy Ferris (MIC 82)
Ms. Sharon Jarvis (MIC 82)
Mr. Cary Huxoll (MIC 82)
Ms. Janice Thurston (via e-mail)
Ms. Jean Ogrod (via e-mail)
Mr. Jeff Vest (via e-mail)
Mr. David Levine (MIC 85)
Ms. Elizabeth Abreu (via e-mail)
Mr. Steve Ryan (MIC 85)
Mr. Rey Obligacion (via e-mail)
Mr. Todd Gilman (MIC 70)
Mr. Kenneth Topper (via e-mail)
Mr. Dave Hayes (MIC 67)
Ms. Freda Orendt (via e-mail)
Mr. Stephen Rudd (via e-mail)
Mr. Joseph Young (via e-mail)
Mr. Jeffrey L. McGuire (MIC 92 and via e-mail)
Mr. Vic Anderson (MIC 44 and via e-mail)
Mr. Larry Bergkamp (via e-mail)
Mr. Cornell Yip (via e-mail)
Mr. Geoffrey E. Lyle (MIC 50)
Ms. Leila Khabbaz (MIC 50)
Ms. Cecilia Watkins (MIC 50)
Ms. Lisa Andrews (MIC 50)

**AGENDA —September 27, 2006 Business Taxes Committee Meeting
Regulation 1603, *Taxable Sales of Food Products***

<p>Issue Paper Alternative 3 - California Hotel and Lodging Association's recommendation</p> <p>Agenda pages 3-8</p> <p>Action 1 (Continued)</p> <p>Issue Paper Alternative 4 –Mr. Charles Moll's recommendation</p> <p>Agenda pages 3-8</p>	<p align="center">OR</p> <p>Proposed revisions would provide a rebuttable presumption that:</p> <ul style="list-style-type: none"> • Amounts designated by the retailer as a “service charge” are mandatory and subject to tax, even if the charge is itemized on the invoice as “optional service charge.” For example, the statement “a 15% service charge will be added for parties of 8 or more” would mean the charge is mandatory and should be included in taxable gross receipts. • Amounts designated as “tips” or “gratuities” are voluntarily left by patrons and not subject to tax. For example, the statement “a suggested gratuity of 15% will be added for parties of 8 or more” would mean the charge is a voluntary payment by the customer and should be excluded from taxable gross receipts. <p align="center">OR</p> <p>Proposed revisions would delete all references to mandatory and optional charges from the regulation and also provide a rebuttable presumption that:</p> <ul style="list-style-type: none"> • Amounts designated by the retailer as a “service charge” are consideration paid for the meal and are subject to tax, even if the charge is itemized on the billing with a notation such as “optional.” For example, the statement “a 15% service charge will be added for parties of 8 or more” would mean the charge is subject to tax. • Amounts designated as “tips” or “gratuities” are consideration for the server and not for the meal, and are not subject to tax. For example, the statement “a suggested gratuity of 15% will be added for parties of 8 or more” would mean the charge is not subject to tax.
<p>Action 2 – Authorization to Publish</p>	<p>Recommend publication of amendments to Regulation 1603 as adopted in the above actions.</p> <p>Operative Date: None</p> <p>Implementation: 30 days following OAL approval</p>

**AGENDA —September 27, 2006 Business Taxes Committee Meeting
Regulation 1603, *Taxable Sales of Food Products***

Action Item 1 — Application of Tax to Charges for Tips Gratuities and Service Charges.			
Regulatory Language Proposed by Staff	Regulatory Language Proposed by CRA	Regulatory Language Proposed by CHLA	Regulatory Language Proposed by Mr. Moll
<p>Regulation 1603 ... <u>(g) TIPS, GRATUITIES, AND SERVICE CHARGES.</u> <u>This subdivision applies to restaurants, hotels, caterers, boarding houses, soda fountains, drive-ins and similar establishments.</u> <u>An optional charge designated as a tip, gratuity, or service charge is not subject to tax. A mandatory charge designated as a tip, gratuity, or service charge is included in taxable gross receipts.</u> <u>_____ (1) OPTIONAL CHARGE.</u> <u>_____ (A) A charge for 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. If an employer misappropriates payments for these charges, as discussed in subdivision (g)(1)(B) below, such payments are included in the retailer’s taxable gross receipts.</u></p>	<p>Regulation 1603 ... <u>(g) TIPS AND GRATUITIES SERVICE CHARGES.</u></p>	<p>Regulation 1603 ... <u>(g) TIPS, GRATUITIES, AND SERVICE CHARGES.</u> <u>This subdivision applies to restaurants, hotels, caterers, boarding houses, soda fountains, drive-ins and similar establishments.</u> <u>_____ (1) An optional amount voluntarily left by a guest or patron (typically characterized as a “tip” or a “gratuity”) is not subject to tax. In contrast, a mandatory charge imposed by the retailer (typically characterized as a “service charge”) is included in taxable gross receipts.</u></p>	<p>Regulation 1603 ... <u>(g) TIPS, GRATUITIES, AND SERVICE CHARGES.</u> <u>This subdivision applies to restaurants, hotels, caterers, boarding houses, soda fountains, drive-ins and similar establishments.</u> <u>_____ (1) An amount left by a guest or patron for the server (typically characterized as a “tip” or a “gratuity”) is not subject to tax. In contrast, a charge imposed by the retailer (typically characterized as a “service charge”) is included in taxable gross receipts.</u></p>

**AGENDA —September 27, 2006 Business Taxes Committee Meeting
Regulation 1603, Taxable Sales of Food Products**

Action Item 1 — Application of Tax to Charges for Tips Gratuities and Service Charges.

Regulatory Language Proposed by Staff	Regulatory Language Proposed by CRA	Regulatory Language Proposed by CHLA	Regulatory Language Proposed by Mr. Moll
<p><u>(B)</u> 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.</p> <p><u>(2) MANDATORY CHARGE.</u></p> <p><u>(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.</u></p>	<p>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.</p> <p>Amounts designated as service charges, <u>negotiated in advance of an event between the caterer and the customer, and</u> 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 employees.</p>	<p><u>(2) An amount negotiated between a restaurant, hotel, caterer, boarding house, soda foundation, drive-in or similar establishment and the customer in advance of a meal, food, drinks, or an event that includes a meal, food, or drinks is mandatory even though the amount or percentage is negotiated. Thus, language such as “A 15% service charge will be added for parties of 8 or more” will be deemed to be mandatory in nature and included in taxable gross receipts.</u></p>	<p><u>(2) A service charge negotiated between a restaurant, hotel, caterer, boarding house, soda foundation, drive-in or similar establishment and the customer in advance of a meal, food, drinks, or an event that includes a meal, food, or drinks, is included in gross taxable receipts even though the amount or percentage is negotiated. Thus, where a service charge is imposed pursuant to language such as “A 15% service charge will be added for parties of 8 or more” that charge will be included in taxable gross receipts.</u></p>

**AGENDA —September 27, 2006 Business Taxes Committee Meeting
Regulation 1603, Taxable Sales of Food Products**

Action Item 1 — Application of Tax to Charges for Tips Gratuities and Service Charges.

Regulatory Language Proposed by Staff	Regulatory Language Proposed by CRA	Regulatory Language Proposed by CHLA	Regulatory Language Proposed by Mr. Moll
<p><u>(B) An amount added by the retailer to the bill or invoice presented to the customer is presumed to be 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 paid by the customer. This presumption may be controverted by documentary evidence showing that the customer specifically requested and authorized the gratuity be added to the amount billed.</u></p> <p><u>(C) Printed statements on menus, brochures or advertisements that tips, gratuities, or service charges will or may be added to the prices of meals, food, or drinks are evidence that the amounts billed by the retailer and paid by customers are mandatory and subject to tax. Examples of printed statements include:</u></p> <p><u>“An 18% gratuity [or service charge] will be added to parties of 8 or more.”</u></p> <p><u>“Suggested gratuity 15%,” itemized on the invoice or bill</u></p>		<p><u>(3) An amount itemized on an invoice or billing by a restaurant, hotel, caterer, boarding house, soda foundation, drive-in or similar establishment is not optional but is regarded as mandatory, even if the invoice or billing itemizes it with a notation such as “optional service charge.”</u></p> <p><u>(4) A gratuity is optional only if it is voluntarily added by the customer. Language such as “A suggested gratuity [or amount] of 15% will be added for parties of 8 or more” will be deemed to indicate a voluntary payment by the customer and therefore not included in taxable gross receipts.</u></p>	<p><u>(3) A service charge itemized on an invoice or billing by a restaurant, hotel, caterer, boarding house, soda foundation, drive-in or similar establishment is included in taxable gross receipts even if the invoice or billing itemizes it with a notation such as “optional service charge.”</u></p> <p><u>(4) A gratuity or a “tip” is an amount left by the customer, typically for the server, including such amounts calculated or physically added to the invoice by the retailer. Language on a menu such as “A suggested gratuity of 15% will be added for parties of 8 or more” will be deemed to indicate a payment by the customer for the server which is not included in taxable gross receipts.</u></p>

**AGENDA —September 27, 2006 Business Taxes Committee Meeting
Regulation 1603, Taxable Sales of Food Products**

Action Item 1 — Application of Tax to Charges for Tips Gratuities and Service Charges.

Regulatory Language Proposed by Staff	Regulatory Language Proposed by CRA	Regulatory Language Proposed by CHLA	Regulatory Language Proposed by Mr. Moll
<p><u>by the restaurant, hotel, caterer, boarding house, soda fountain, drive-in or similar establishment.</u></p> <p><u>“A 15% voluntary gratuity will be added for parties of 8 or more.”</u></p> <p><u>(D) Mandatory charges</u> 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 if such service charges are made in lieu of tips and are paid over by the retailer to employees.</p>		<p><u>(5) 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.</u></p>	<p><u>(5) 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.</u></p>

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Regulation 1603, Taxable Sales of Food Products**

Action Item 1 — Application of Tax to Charges for Tips Gratuities and Service Charges.

Regulatory Language Proposed by Staff	Regulatory Language Proposed by CRA	Regulatory Language Proposed by CHLA	Regulatory Language Proposed by Mr. Moll
<p>(h) CATERERS. ... (3) SALES BY CATERERS. (E) Tips, Gratuities, or Service Charges. An optional tip or gratuity is not subject to tax. A mandatory tip, gratuity, or service charge is included in taxable gross receipts. A tip, gratuity, or service charge negotiated in advance of an</p>	<p>(h) CATERERS. ... (3) SALES BY CATERERS. (E) Tips, Gratuities, or Service Charges. An optional tip or gratuity is not subject to tax. A mandatory service charge is included in taxable gross receipts. A tip, gratuity, or service charge negotiated in advance of an event</p>	<p><u>(A)</u> 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 employees.</p> <p><u>(6)</u> Consistent with the foregoing, there shall be a rebuttable presumption that amounts designated by the retailer as a “service charge” are mandatory in nature, and therefore subject to tax, whereas amounts designated as “tips” or “gratuities” have been voluntarily left by the patrons, and therefore not subject to tax.</p> <p>(h) CATERERS. ... (3) SALES BY CATERERS. (E) Tips, Gratuities, or Service Charges. An optional tip or gratuity is not subject to tax. A mandatory tip, gratuity, or service charge is included in taxable gross receipts. A tip, gratuity, or service charge negotiated in advance of an</p>	<p><u>A</u> 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 employees.</p> <p><u>(6)</u> Consistent with the foregoing, there shall be a rebuttable presumption that amounts designated by the retailer as a “service charge” are consideration paid for the meal and are included in taxable gross receipts, whereas amounts designated as “tips” or “gratuities” left by the patrons are consideration for the server and not for the meal, and therefore are not included in taxable gross receipts.</p> <p>(h) CATERERS. ... (3) SALES BY CATERERS. (E) Tips, Gratuities, or Service Charges. An optional tip or gratuity is not subject to tax. A mandatory tip, gratuity, or service charge is included in taxable gross receipts. A tip, gratuity, or service charge negotiated in advance of an</p>

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Regulation 1603, Taxable Sales of Food Products**

Action Item 1 — Application of Tax to Charges for Tips Gratuities and Service Charges.			
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<p>event between the caterer and the customer is mandatory even though the amount or percentage is negotiated. A tip, gratuity, or service charge itemized on an invoice or billing by a caterer is not optional even if the invoice or billing itemizes with a notation such as “optional gratuity.” A gratuity is optional only if it is voluntarily added by the customer. Examples of mandatory tips, gratuities, or service charges include:</p> <p style="padding-left: 40px;">“A 15% gratuity [or service charge] will be added to parties of 8 or more.”</p> <p style="padding-left: 40px;">“Suggested gratuity 15%,” itemized on the invoice or bill by the caterer.</p> <p>Tips, gratuities, and service charges are discussed in subdivision (g).</p>	<p>between the caterer and the customer is mandatory even though the amount or percentage is negotiated. A tip, gratuity, or service charge itemized on an invoice or billing by a caterer is not optional even if the invoice or billing itemizes with a notation such as “optional gratuity.” A gratuity is optional only if it is voluntarily added by the customer. Examples of mandatory tips, gratuities, or service charges include:</p> <p style="padding-left: 40px;">“A 15% gratuity [or service charge] will be added to parties of 8 or more.”</p> <p style="padding-left: 40px;">“Suggested gratuity 15%,” itemized on the invoice or bill by the caterer.</p> <p>Tips, gratuities, and service charges are further discussed in subdivision (g).</p>	<p>event between the caterer and the customer is mandatory even though the amount or percentage is negotiated. A tip, gratuity, or service charge itemized on an invoice or billing by a caterer is not optional even if the invoice or billing itemizes with a notation such as “optional gratuity.” A gratuity is optional only if it is voluntarily added by the customer. Examples of mandatory tips, gratuities, or service charges include:</p> <p style="padding-left: 40px;">“A 15% gratuity [or service charge] will be added to parties of 8 or more.”</p> <p style="padding-left: 40px;">“Suggested gratuity 15%,” itemized on the invoice or bill by the caterer.</p> <p>Tips, gratuities, and service charges are further discussed in subdivision (g).</p>	<p>event between the caterer and the customer is mandatory even though the amount or percentage is negotiated. A tip, gratuity, or service charge itemized on an invoice or billing by a caterer is not optional even if the invoice or billing itemizes with a notation such as “optional gratuity.” A gratuity is optional only if it is voluntarily added by the customer. Examples of mandatory tips, gratuities, or service charges include:</p> <p style="padding-left: 40px;">“A 15% gratuity [or service charge] will be added to parties of 8 or more.”</p> <p style="padding-left: 40px;">“Suggested gratuity 15%,” itemized on the invoice or bill by the caterer.</p> <p>Tips, gratuities, and service charges are further discussed in subdivision (g).</p>

Issue Paper Number **06 - 004**

- Board Meeting
- Business Taxes Committee
- Customer Services and Administrative Efficiency Committee
- Legislative Committee
- Property Tax Committee
- Other



Proposed Revisions to Regulation 1603, Taxable Sales of Food Products, Regarding the Application of Tax to Charges for Mandatory and Optional Gratuities

I. Issue

Should Regulation 1603, *Taxable Sales of Food Products*, be amended to clarify the application of tax to charges for mandatory and optional gratuities?

II. Alternative 1 - Staff Recommendation

Staff recommends that subdivision (g) of Regulation 1603 be expanded to clarify the current application of tax, as follows:

- An amount, whether designated as a tip, gratuity, or service charge, is optional and not subject to tax when it is added to the bill by the customer or otherwise left by the customer in payment over and above the actual amount due the retailer.
- An amount, whether designated as a tip, gratuity, or service charge, is presumed to be mandatory and subject to tax when added to the bill by the retailer. Amounts negotiated between the retailer and the customer in advance of a meal or event are mandatory. A statement printed on a menu, advertisement or a brochure advising the customer that a tip, gratuity, or service charge will or may be added to the bill when a group of people exceeds a specified number is evidence that the charge is mandatory and part of the gross receipts from the sale of the meal, food, or drinks. As such, it is subject to tax.

Subdivision (g) would also incorporate and replace the provisions of current subdivision (h)(3)(E) to further clarify that the above provisions apply to retailers selling food and beverages, including restaurants, hotels, caterers, boarding houses, soda fountains, drive-ins, and similar establishments. Staff's proposed language is attached as Exhibit 2.

III. Other Alternatives Considered

The California Restaurant Association (CRA), the California Hotel and Lodging Association (CHLA), and Mr. Charles Moll of Winston and Strawn (Moll), conceptually agree to amending subdivisions (g) and (h)(3)(E) of the regulation to provide that amounts designated as "service charges" are part of gross receipts and subject to tax, whereas amounts designated as "tips" or "gratuities" are not subject to tax. However, each party submitted separate language for Committee consideration. Following are Alternatives 2, 3, and 4 to the staff recommendation:

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Alternative 2 - CRA's Proposal (attached as Exhibit 3)

- Amend subdivisions (g) and (h)(3)(E) to provide that amounts designated as service charges, negotiated in advance of an event between the caterer and the customer, and added to the price of meals, are part of the selling price of the meal and subject to tax.
- Amend subdivision (h)(3)(E) to delete language and examples referring to “mandatory” tips and gratuities and retain the statement “an optional tip or gratuity is not subject to tax.”

Alternative 3 - CHLA's Proposal (attached as Exhibit 4)

- Delete the provisions of subdivision (h)(3)(E) and incorporate them in amended subdivision (g) to provide a rebuttable presumption that:
- Amounts designated by the retailer as a “service charge” are mandatory and subject to tax, even if the charge is itemized on the invoice as “optional service charge.” For example, the statement “a 15% service charge will be added for parties of 8 or more” would mean the charge is mandatory and should be included in taxable gross receipts.
- Amounts designated as “tips” or “gratuities” are voluntarily left by patrons and not subject to tax. For example, the statement “a suggested gratuity of 15% will be added for parties of 8 or more” would mean the charge is a voluntary payment by the customer and should be excluded from taxable gross receipts.

Alternative 4 – Moll's Proposal (attached as Exhibit 5)

This alternative is similar to Alternative 3 except that it would delete all references to mandatory and optional charges from the regulation. It would also delete the provisions of subdivision (h)(3)(E) and incorporate them in amended subdivision (g) to provide a rebuttable presumption that:

- Amounts designated by the retailer as a “service charge” are consideration paid for the meal and are subject to tax, even if the charge is itemized on the billing with a notation such as “optional.” For example, the statement “a 15% service charge will be added for parties of 8 or more” would mean the charge is subject to tax.
- Amounts designated as “tips” or “gratuities” are consideration for the server and not for the meal, and are not subject to tax. For example, the statement “a suggested gratuity of 15% will be added for parties of 8 or more” would mean the charge is not subject to tax.

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IV. Background

At its November 1, 2005 meeting, the Board of Equalization (Board) heard a case involving the application of tax to tips and gratuities. At issue was whether gratuity charges added by restaurants to customers' checks were optional where a menu notice indicated that the gratuities were voluntary but also included mandatory language that these charges would be added to the checks. The Board's policy generally has been to treat a gratuity added to the bill by the retailer as mandatory, even when a statement on the menu or bill indicates that the gratuity is optional. An amount added to the bill by the customer for a gratuity generally is considered to be optional.

In addition to the discussion at the Board hearing regarding mandatory versus optional charges, the taxpayer suggested that since California Labor Code section 351 provides that no employer or agent may collect, take or receive any part of any gratuity that is paid, given to or left for any employee by a patron, there is no basis for the Board to require the retailer/employer to pay sales tax on such amounts.

The Board directed staff to review this issue and clarify Regulation 1603 where needed.

California imposes sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state, unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code, §6051.) This tax is imposed on the retailer, who may collect tax reimbursement from the customer if the contract of sale so provides. (Civ. Code, §1656.1; Cal. Code Regs., tit. 18, § (Regulation) 1700, subd. (a)(1).)

Unless otherwise exempted by statute, taxable gross receipts include all amounts received with respect to the sale, with no deduction for the cost of materials used, labor or service costs, or any other expense of the retailer passed on to the customer. (Rev. & Tax. Code, §6012, subd. (a)(2)). There is no specific exemption in the Sales and Use Tax Law for amounts billed as tips or gratuities.

Revenue and Taxation Code (RTC) section 6011, subdivision (b)(1) and section 6012, subdivision (b)(1) also provide that the total amount of the sale price includes any services that are part of the sale.

Interested parties meetings were held on June 1, 2006, and July 20, 2006, to discuss proposed amendments to Regulation 1603. Staff and interested parties continue to have differing views regarding the amounts added by restaurants to customers' checks and whether these charges are part of the gross receipts from the sale of the meal and subject to tax. Specifically, the issue relates to gratuity charges added by restaurants to customers' checks for groups of six or more, eight or more, and the like. Typically, in these cases a statement is printed on the menu stating that a percentage will be added by the restaurant for these larger groups. The Business Taxes Committee is scheduled to discuss this issue at its meeting on September 27, 2006.

V. Alternative 1 - Staff Recommendation

Description of the Staff Recommendation

Staff proposes amending Regulation 1603, subdivision (g) to provide that an optional charge designated as a tip, gratuity, or service charge is not part of the retailer's sale of tangible personal property and is therefore not subject to tax. A mandatory charge designated as a tip, gratuity, or service charge is a charge for service that is a part of the retailer's sale of the tangible personal property pursuant to RTC sections 6011 and 6012, and must be included in taxable gross receipts. Staff believes the application of

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tax to these charges is driven by the optional or mandatory nature of the amounts paid by the customer rather than by the retailer's designation of the charge as a "tip," "gratuity" or "service charge." The proposed amendments would define optional and mandatory charges as follows:

Optional Charge

A charge for 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 meals, food, or drinks that include services.

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 subject to the tax.

This provision of section 351 of the Labor Code has been part of Regulation 1603 for a long time to ensure that a nontaxable voluntary gratuity left by the customer for the employee does not escape taxation if it is misappropriated by the retailer and, therefore, becomes part of the gross receipts from the sale.

Mandatory charge

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. These charges typically include amounts for a tip, gratuity, or service charge added by a caterer or a restaurant to pre-planned events related to the furnishing and serving of food, meals, or drinks.

An amount added by the retailer to the bill presented to the customer is presumed to be mandatory, regardless of a notation stating the amount is a "suggested tip" or "optional gratuity" or that "the amount may be increased, decreased, or removed" by the customer. This presumption may be controverted by documentary evidence to show that the customer requested and authorized that the gratuity be added to the amount billed.

A statement printed on a menu that a tip, gratuity, or service charge will or may be added to the meal price is evidence that the amounts billed by the retailer and paid by customers are part of the sale of the meal and subject to tax. In this case, the charge is the result of a standard practice or policy of the retailer and would be considered negotiated in advanced in the same manner as the food item or price on the menu. Such charges are part of gross receipts subject to tax.

The proposed revisions to subdivision (g) would also incorporate and replace the provisions of subdivision (h)(3)(E) to clarify that its provisions apply to restaurants, hotels, caterers, boarding houses, soda fountains, drive-ins, and similar establishments. Staff's proposed revisions are attached as Exhibit 2.

In response to comments made by interested parties that imposing tax on amounts designated as "tips" and "gratuities" is in conflict with the provisions of Labor Code section 351, staff believes RTC sections 6011 and 6012 control and support the current application of tax. In addition, staff believes that its proposed revisions to the regulation are consistent with Labor Code sections 350 and 351.

Issue Paper Number: **U06 - 004U**

The Labor Code is enforced by the Department of Industrial Relations' Division of Labor Standards Enforcement (DIR/DLSE). According to DIR/DLSE's answers to frequently asked question number 6 at http://www.dir.ca.gov/dlse/FAQ_TipsAndGratutities.htm, and a representative from DIR/DLSE who attended the July 20, 2006 interested parties meeting on this issue, a mandatory service charge is an amount that a patron is required to pay based on a contractual agreement or a specified required service amount listed on the menu of an establishment. Such charges are considered owed by the patron to the establishment and are not gratuities voluntarily left for the employees. Therefore, an employer may or may not distribute all or part of this charge to its employees at his or her discretion. What this amount is called does not define what the amount truly represents. The DIR/DLSE enforces these provisions of the Labor Code based on the substance of the charge as opposed to its form. An amount designated by the restaurant as a gratuity is not necessarily a "gratuity," as the term is defined by subdivision (e) of Labor Code section 350. In the case of amounts required to be paid by the customer, proceeds from the charge are solely the property of the employer, even though the restaurant designates the charge as a gratuity. Staff believes the regulation's definition and tax treatment of a mandatory charge is consistent with the Labor Code. The terminology used by the restaurant to describe the charge is not relevant; the substance of the charge determines the application of the law.

A. Pros of the Staff Recommendation

- Clarifies the current application of tax to charges for tips, gratuities and service charges.
- Clarifies that the regulatory language regarding tips, gratuities, and service charges applies to all retailers selling food and beverages such as restaurants, hotels, caterers, boarding houses, soda fountains, drive-ins, and similar establishments.
- The proposed amendments are consistent with the provisions of RTC sections 6011 and 6012.

B. Cons of the Staff Recommendation

- Retailers may have to answer questions raised by their customers in regard to taxation of certain amounts designated by the retailer as "tips," or "gratuities."
- In CRA's opinion, this alternative violates Labor Code section 351.

C. Statutory or Regulatory Change

No statutory change is required. Staff's recommendation requires an amendment to Regulation 1603.

D. Administrative Impact

Staff will be required to notify taxpayers of the amendments to Regulation 1603 through an article in the Tax Information Bulletin (TIB) and update various publications.

E. Fiscal Impact

1. Cost Impact

The workload associated with publishing the regulation and the TIB article, and updating the publications is considered routine and any corresponding cost would be absorbed within the Board's existing budget.

2. Revenue Impact

None. See Revenue Estimate attached as Exhibit 1.

Issue Paper Number: U06 - 004U

F. Taxpayer/Customer Impact

None.

G. Critical Time Frames

None. The amended regulation will become effective 30 days after approval by the State Office of Administrative Law.

VI. Alternative 2 - CRA's Proposal

A. Description of the Alternative

CRA's proposed amendments to subdivisions (g) and (h)(3)(E) delete references and examples of mandatory tips and gratuities from the regulation and limit the imposition of tax to charges designated as "service charges" that are negotiated in advance of an event between a caterer and the customer. CRA's proposed revisions and full submission are attached as Exhibit 3.

CRA believes amounts designated as "tips" and "gratuities" are optional charges in all cases and are the property of the retailer's employees. For this reason, there is no basis for a regulatory policy or audit procedure that results in the imposition of a sales tax on the property of the employees of the restaurant. Therefore, no amount of tips or gratuities that belong to the employees and are passed on to the employees in compliance with Labor Code section 351 should be included in the taxable measure of gross receipts for purposes of calculating the sales tax.

CRA notes that Regulation 1603 has long had Labor Code section 351 expressly stated in subdivision (g). Therefore, the regulation should be within the scope of Labor Code section 351 and be in line with its intent and purpose. In CRA's opinion, the current provisions of the regulation are forcing tips to become property of the employer in certain circumstances and this is contrary to the governing statute.

B. Pros of Alternative 2 - CRA's Proposal

- In CRA's opinion, this alternative provides a "bright line" test by basing the imposition of tax on the designation of the charge.
- In CRA's opinion, this alternative will accurately reflect the restaurant dining room setting and will accurately apply the statutory provisions of the Sales and Use Tax Law and the Labor Code.

C. Cons of the Alternative 2 - CRA's Proposal

- In staff's opinion, the proposed amendments are inconsistent with the provisions of RTC sections 6011 and 6012 and Labor Code section 350 and 351. Under this proposal, the terminology used by the restaurant to describe the charge rather than the substance of the charge would determine the application of the tax.
- Does not clarify that the regulatory language regarding tips, gratuities, and service charges applies to all retailers selling food and beverages such as restaurants, hotels, caterers, boarding houses, soda fountains, drive-ins, and similar establishments, as it does not address "service charges" negotiated in advance of an event between the retailers selling food and beverages such as restaurants, hotels, boarding houses, soda fountains, drive-ins, and similar establishments (it only addresses caterers).
- Creates a potential for refunds since the effect of this regulatory amendment is retroactive.

Issue Paper Number: **U06 - 004U**

D. Statutory or Regulatory Change

Requires amendments to Regulation 1603.

E. Administrative Impact

Staff will be required to notify taxpayers of the amendments to Regulation 1603 through an article in the TIB and update various publications.

F. Fiscal Impact

1. Cost Impact

The workload associated with publishing the regulation and the TIB article, and updating the publications is considered routine and any corresponding cost would be absorbed within the Board's existing budget. Any potential for claims for refund under this alternative would most likely be from taxpayers who paid the tax without collecting tax reimbursement from their customers. Therefore, the cost impact from these refunds is expected to be limited and handled within the Board's existing budget.

2. Revenue Impact

The revenue loss impact is estimated to be \$2.5 million annually. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Restaurants would no longer be required to include amounts they designate as gratuities or tips in their taxable gross receipts from sales of food and beverages.

H. Critical Time Frames

The proposed amendment represents an interpretation of existing statutes and, therefore, has no operative date. Implementation will take place 30 days following approval of the regulation by the State Office of Administrative Law.

VII. Alternative 3 – CHLA's Proposal

A. Description of the Alternative

CHLA's proposed amendments would apply to restaurants, hotels, caterers, and similar establishments. They would provide a rebuttable presumption that amounts designated by the retailer as "service charges" are mandatory. Therefore, a statement added by the retailer stating that "a 15% service charge will be added for parties of 8 or more" will be deemed to be mandatory and the amount added by the retailer to the customer's invoice must be included in taxable gross receipts.

The proposal would also provide a rebuttable presumption that amounts designated as "tips" or "gratuities" have been voluntarily left by the patrons. Therefore, a statement added by the retailer stating that "a suggested gratuity [or amount] of 15% will be added for parties of 8 or more" will be deemed to be a voluntary payment by the customer, and the amount added by the retailer to the customer's invoice is not subject to tax. CHLA proposed revisions and full submission are attached as Exhibit 4.

Issue Paper Number: **U06 - 004U**

CHLA recognizes that at issue is the restaurants' practice of adding an amount to a customer's check to make sure their employees receive an appropriate tip when waiting on groups of six or more, eight or more, and the like. CHLA explains that retailers often find that there is confusion among the customers in the party as to who is going to leave a tip and how much it should be. This frequently leads to situations in which an inappropriately small voluntary gratuity is left, which deprives the service personnel of gratuities they would otherwise receive. To address this problem, many restaurants have resorted to inserting an amount or percentage for a tip or gratuity into the process by use of such language as, "A 15% gratuity will be added for parties of 8 or more." CHLA believes that the fact that language such as this is added to the menus does not change the fact that the amount left by the customers is intended by the customers to be used as a typical tip or gratuity. That is, the employer-retailer is never claiming any right, title, or interest in or to the money, and recognizes that the amount left at all times belongs solely to the employees, as specified in Labor Code Sections 351, et seq., and acts solely as a conduit to transmit the tip or gratuity to the appropriate employees.

B. Pros of Alternative 3 – CHLA's Proposal

- In CHLA's opinion, it provides a "bright line" test by basing the imposition of tax on the designation of the charge.
- Clarifies that the regulatory language regarding tips, gratuities, and service charges applies to all retailers selling food and beverages such as restaurants, hotels, caterers, boarding houses, soda fountains, drive-ins, and similar establishments.

C. Cons of the Alternative 3 – CHLA's Proposal

- In staff's opinion, the proposed amendments are inconsistent with the provisions of RTC sections 6011 and 6012 and Labor Code section 350 and 351. Under this proposal, the terminology used by the restaurant to describe the charge rather than the substance of the charge would determine the application of the tax.
- Creates a potential for refunds since the effect of this regulatory amendment is retroactive.

D. Statutory or Regulatory Change

Requires amendments to Regulation 1603.

E. Administrative Impact

Staff will be required to notify taxpayers of the amendments to Regulation 1603 through an article in the TIB and update various publications.

F. Fiscal Impact

1. Cost Impact

The workload associated with publishing the regulation and the TIB article, and updating various publications is considered routine and any corresponding cost would be absorbed within the Board's existing budget. Any potential for claims for refund under this alternative would most likely be from taxpayers who paid the tax without collecting tax reimbursement from their customers. Therefore, the cost impact from these refunds is expected to be limited and handled within the Board's existing budget.

Issue Paper Number: U06 - 004U

2. Revenue Impact

The revenue loss impact is estimated to be \$2.5 million annually. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Restaurants would no longer be required to include amounts they designate as gratuities or tips in their taxable gross receipts from sales of food and beverages.

H. Critical Time Frames

None. The amended regulation will become effective 30 days after approval by the State Office of Administrative Law.

VIII. Alternative 4 - Moll's Proposal

A. Description of the Alternative

Moll's proposed amendments would apply to restaurants, hotels, caterers, and similar establishments and would provide a rebuttable presumption that amounts designated by the retailer as "service charges" are consideration paid for the meal. Therefore, a statement added by the retailer stating that "a 15% service charge will be added for parties of 8 or more" would mean the service charge must be included in the retailer's taxable gross receipts.

Amounts designated as "tips" or "gratuities" left by the patrons or added to the invoice by the retailer are consideration for the server and not for the meal. Therefore, a statement added by the retailer providing that "a suggested gratuity of 15% will be added for parties of 8 or more" will be deemed to indicate a payment by the customer for the server that is not subject to tax. Moll's proposed revisions and full submission are attached as Exhibit 5.

This alternative is based on Mr. Moll's opinion that the distinction between a mandatory and optional tip and gratuity is not found in the Revenue and Taxation Code. An amount paid as a tip would be taxable if it was a payment for tangible personal property. Otherwise, it is not subject to tax, regardless as to whether that payment is voluntary or mandatory. The focus should be on the purpose of the tip paid. If for food, tax applies. However, if the tip is intended as compensation for the server's services, it is not a payment for tangible personal property and must not be included in the taxable measure.

B. Pros of Alternative 4 – Moll's Proposal

- In Moll's opinion, this alternative provides a "bright line" test by basing the imposition of tax on the designation of the charge.
- Clarifies that the regulatory language regarding tips, gratuities, and service charges applies to all retailers selling food and beverages such as restaurants, hotels, caterers, boarding houses, soda fountains, drive-ins, and similar establishments.

Issue Paper Number: U06 - 004U

C. Cons of Alternative 4 – Moll’s Proposal

- In staff’s opinion, the proposed amendments are inconsistent with the provisions of RTC sections 6011 and 6012 and Labor Code section 350 and 351. Under this proposal, the terminology used by the restaurant to describe the charge rather than the substance of the charge would determine the application of the tax.
- Creates a potential for refunds since the effect of this regulatory amendment is retroactive.

D. Statutory or Regulatory Change

Requires amendments to Regulation 1603.

E. Administrative Impact

Staff will be required to notify taxpayers of the amendments to Regulation 1603 through an article in the TIB and update various publications.

F. Fiscal Impact

1. Cost Impact

The workload associated with publishing the regulation and the TIB article, and updating various publications is considered routine and any corresponding cost would be absorbed within the Board’s existing budget. Any potential for claims for refund under this alternative would most likely be from taxpayers who paid the tax without collecting tax reimbursement from their customers. Therefore, the cost impact from these refunds is expected to be limited and handled within the Board’s existing budget.

2. Revenue Impact

The revenue loss impact is estimated to be \$2.5 million annually. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Restaurants would no longer be required to include amounts designated as gratuities or tips in their taxable sales of food and beverages.

H. Critical Time Frames

None. The amended regulation will become effective 30 days after approval by the State Office of Administrative Law.

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

Current as of: 9-13-06



Proposed Revisions to Regulation 1603, Taxable Sales of Food Products, Regarding the Application of Tax to Charges for Mandatory and Optional Gratuities

Alternative 1 - Staff Recommendation

Staff recommends that subdivision (g) of Regulation 1603 be expanded to clarify the current application of tax, as follows:

- An amount, whether designated as a tip, gratuity, or service charge, is optional and not subject to tax when it is added to the bill by the customer or otherwise left by the customer in payment over and above the actual amount due the retailer.
- An amount, whether designated as a tip, gratuity, or service charge, is presumed to be mandatory and subject to tax when added to the bill by the retailer. Amounts negotiated between the retailer and the customer in advance of a meal or event are mandatory. A statement printed on a menu, advertisement or a brochure advising the customer that a tip, gratuity, or service charge will or may be added to the bill when a group of people exceeds a specified number is evidence that the charge is mandatory and part of the gross receipts from the sale of the meal, food, or drinks. As such, it is subject to tax.

Subdivision (g) would also incorporate and replace the provisions of current subdivision (h)(3)(E) to further clarify that the above provisions apply to retailers selling food and beverages, including restaurants, hotels, caterers, boarding houses, soda fountains, drive-ins, and similar establishments. Staff's proposed language is attached as Exhibit 2.

Other Alternative Considered

The California Restaurant Association (CRA), the California Hotel and Lodging Association (CHLA), and Mr. Charles Moll of Winston and Strawn (Moll), conceptually agree to amending subdivisions (g) and (h)(3)(E) of the regulation to provide that amounts designated as "service charges" are part of gross receipts and subject to tax, whereas amounts designated as "tips" or "gratuities" are not subject to tax. However, each party submitted separate

Revenue Estimate

language for Committee consideration. Following are Alternatives 2, 3, and 4 to the staff recommendation:

Alternative 2 - CRA's Proposal (see Exhibit 3)

- Amend subdivisions (g) and (h)(3)(E) to provide that amounts designated as service charges, negotiated in advance of an event between the caterer and the customer, and added to the price of meals, are part of the selling price of the meal and subject to tax.
- Amend subdivision (h)(3)(E) to delete language and examples referring to “mandatory” tips and gratuities and retain the statement “an optional tip or gratuity is not subject to tax.”

Alternative 3 - CHLA's Proposal (see Exhibit 4)

Delete the provisions of subdivision (h)(3)(E) and incorporate them in amended subdivision (g) to provide a rebuttable presumption that:

- Amounts designated by the retailer as a “service charge” are mandatory and subject to tax, even if the charge is itemized on the invoice as “optional service charge.” For example, the statement “a 15% service charge will be added for parties of 8 or more” would mean the charge is mandatory and should be included in taxable gross receipts.
- Amounts designated as “tips” or “gratuities” are voluntarily left by patrons and not subject to tax. For example, the statement “a suggested gratuity of 15% will be added for parties of 8 or more” would mean the charge is a voluntary payment by the customer and should be excluded from taxable gross receipts.

Alternative 4 – Moll's Proposal (see Exhibit 5)

This alternative is similar to Alternative 3 except that it would delete all references to mandatory and optional charges from the regulation. It would also delete the provisions of subdivision (h)(3)(E) and incorporate them in amended subdivision (g) to provide a rebuttable presumption that:

- Amounts designated by the retailer as a “service charge” are consideration paid for the meal and are subject to tax, even if the charge is itemized on the billing with a notation such as “optional.” For example, the statement “a 15% service charge will be added for parties of 8 or more” would mean the charge is subject to tax.
- Amounts designated as “tips” or “gratuities” are consideration for the server and not for the meal, and are not subject to tax. For example, the statement “a suggested gratuity of 15% will be added for parties of 8 or more” would mean the charge is not subject to tax.

Background, Methodology, and Assumptions**Alternative 1 - Staff Recommendation**

Staff proposes amending Regulation 1603, subdivision (g) to provide that an optional charge designated as a tip, gratuity, or service charge is not part of the retailer's sale of tangible personal property and is therefore not subject to tax. A mandatory charge designated as a tip, gratuity, or service charge is a charge for service that is a part of the retailer's sale of the tangible personal property pursuant to RTC sections 6011 and 6012, and must be included in taxable gross receipts. Staff asserts that an amount added by the retailer to the bill presented to the customer is presumed to be mandatory, regardless of a notation stating the amount is a

Revenue Estimate

“suggested tip” or “optional gratuity.” This presumption may be contested by documentary evidence to show that the customer requested and authorized that the gratuity be added to the amount billed. A statement printed on a menu that a tip, gratuity, or service charge will or may be added to the meal price is evidence that the amounts billed by the retailer and paid by customers are part of the sale of the meal and subject to tax. In this case, the charge is the result of a standard practice or policy of the retailer and becomes part of the contract for the sale of the meal. Staff believes the application of tax to these charges is driven by the optional or mandatory nature of the amounts paid by the customer rather than by the retailer’s designation of the charge as a “tip,” “gratuity” or “service charge.” The proposed amendments would clarify the Board’s definition of optional and mandatory charges and the application of tax to these charges currently in practice. Alternative 1 does not have a revenue impact.

Other Alternatives Considered

The revenue impact for Alternative 2, 3, and 4 would in essence be the same. All three alternatives assert that service charges are always part of taxable gross receipts when negotiated in advance between the patron and the taxpayer.

Alternative 2

Proponents of Alternative 2 assert that no amount of tips or gratuities that belong to the employees and are passed on to the employees in compliance with Labor Code Section 351 should be included in the taxable measure of gross receipts for purposes of calculating the sales tax. Proponents assert that the Board has taken the position that almost any statement by the restaurant owner with regard to tipping “obligates” the customer to pay a tip and makes the tip subject to sales tax. However, they believe this distinction is made moot by the fact that tips are the property of the employees of the restaurant and, as such, are not subject to a sales tax imposed on the restaurant owner by the Board.

Alternative 3

Proponents of Alternative 3 assert that many food service operators have resorted to inserting an appropriately sized tip/gratuity into the process by use of such language as, “A 15% gratuity will be added for parties of 8 or more.” The fact that language such as this is utilized does not change the fact that the amount left by the customers is exactly like, and is intended by the customers to be used as, a typical voluntarily tip/gratuity. That is, the employer/retailer is never claiming any right, title, or interest in or to the money, recognizes that the amount left at all times belongs solely to the employees, as specified in Labor Code Sections 351, et seq., and acts solely as a conduit to transmit the tip/gratuity to the appropriate employees.

Alternative 4

This alternative is similar to Alternative 3 except that it would delete all references to mandatory and optional charges from the regulation. Proponents of Alternative 4 assert that simply identifying whether a payment is “mandatory” or “voluntary” is not, by itself, a litmus test for deciding whether payment is for tangible personal property or not.

Revenue Estimate**Revenue Impact**

Since all three other alternatives have essentially the same revenue impact, we have provided one revenue estimate to address all of the other alternatives. This estimate is based on a review of audits covering fiscal years 2002-03, 2003-04, and 2004-05. In order to determine the revenue estimate we have made some judgments and assumptions about the taxable measure impacted by the other alternatives. Specifically, we have not included audit errors found in limited service restaurants serving only beer and wine. In addition, we have not included audit errors found in hotels with and without on-sale general alcoholic beverage licenses. This estimate only includes eating and drinking places with on-sale general alcoholic beverage licenses (business code 36).

For the three year period ending June 30, 2005, staff reviewed 4.71% of all eligible business code 36 accounts. The taxable measure in the audit sample represented 13.5% of the total taxable measure of all eligible accounts reported to business code 36. The audit resulted in reportable errors of \$1 million related to tips and service charges for the three year period. Using the audit error we extrapolated the revenue impact from total taxable measure represented in the sample for all business code 36 accounts. The revenue impact for other alternatives is as follows:

	<u>Revenue loss</u>
Tips and service charges reported audit error	\$ 1,000,000
Taxable measure represented in sample	13.5%
Estimated revenue impact for 3-year period	<u>\$ 7,400,000</u>
Estimated annual revenue loss (business code 36)	<u><u>\$ 2,470,000</u></u>

Revenue Summary

Alternative 1 – This alternative does not have a revenue impact.

Other alternatives considered - other alternatives will have an annual revenue impact of \$2.5 million.

Preparation

Mr. Bill Benson, Jr., Research and Statistics Section, Legislative and Research Division, prepared this revenue estimate. Mr. Dave Hayes, Manager, Research and Statistics Section, Legislative and Research Division, and Mr. Jeff McGuire, Tax Policy Manager, Sales and Use Tax Department, reviewed this revenue estimate. For additional information, please contact Mr. Benson at (916) 445 0840.

Regulation 1603. TAXABLE SALES OF FOOD PRODUCTS.

References: Sections 6006, 6012, 6359, 6359.1, 6359.45, 6361, 6363, 6363.5, 6363.6, 6370, 6373, 6374 and 6376.5, Revenue and Taxation Code.
Food Products Generally, see Regulation 1602.
Alcoholic Beverages, tax reimbursement when served with, see Regulation 1700.
"Free" meals with purchased meals, see Regulation 1670.
Meals served to patients and inmates of an institution, see Regulation 1503.
Vending Machines, when considered selling meals, see Regulation 1574.
Meals at summer camps, see Regulation 1506 (e).
Parent-Teacher associations as consumers, see Regulation 1597.

(a) RESTAURANTS, HOTELS, BOARDING HOUSES, SODA FOUNTAINS, AND SIMILAR ESTABLISHMENTS.

(1) DEFINITIONS.

(A) Boarding House. The term "boarding house" as used in this regulation means any establishment regularly serving meals, on the average to five or more paying guests. The term includes a "guest home," "residential care home," "halfway house," and any other establishment providing room and board or board only, which is not an institution as defined in Regulation 1503 and Section 6363.6 of the Revenue and Taxation Code. The fact that guests may be recipients of welfare funds does not affect the application of tax. A person or establishment furnishing meals on the average to fewer than five paying guests during the calendar quarter is not considered to be engaged in the business of selling meals at retail.

(B) American Plan Hotel. The term "American Plan Hotel" as used in this regulation means a hotel which charges guests a fixed sum by the day, week, or other period for room and meals combined.

(C) Complimentary Food and Beverages. As used in this subdivision (a), the term "complimentary food and beverages" means food and beverages (including alcoholic and non-alcoholic beverages) which are provided to transient guests on a complimentary basis and:

1. There is no segregation between the charges for rooms and the charges for the food and beverages on the guests' bills, and
2. The guests are not given an option to refuse the food and beverages in return for a discounted room rental.

(D) Average Retail Value of Complimentary Food and Beverages. The term "average retail value of complimentary food and beverages" (ARV) as used in this regulation means the total amount of the costs of the complimentary food and beverages for the preceding calendar year marked-up one hundred percent (100%) and divided by the number of rooms rented for that year. Costs of complimentary food and beverages include charges for delivery to the lodging establishment but exclude discounts taken and sales tax reimbursement paid to vendors. The 100% markup factor includes the cost of food preparation labor by hotel employees, the fair rental value of hotel facilities used to prepare or serve the food and beverages, and profit.

(E) Average Daily Rate. The term "average daily rate" (ADR) as used in this regulation means the gross room revenue for the preceding calendar year divided by the number of rooms rented for that year. "Gross room revenue" means and includes the full charge to the hotel customers but excludes separately stated occupancy taxes, revenue from contract and group rentals which do not qualify for complimentary food and beverages, and revenue from special packages (e.g., New Year's Eve packages which include food and beverages as well as guest room accommodations), unless it can be documented that the retail value of the food and beverages provided as a part of the special package is 10% or less of the total package charge as provided in subdivision (a)(2)(B). "Number of rooms rented for that year" means the total number of times all rooms have been rented on a nightly basis provided the revenue for those rooms is included in the "gross room revenue". For example, if a room is rented out for three consecutive nights by one guest, that room will be counted as rented three times when computing the ADR.

(2) APPLICATION OF TAX.

(A) In General. Tax applies to sales of meals or hot prepared food products (see (e) below) furnished by restaurants, concessionaires, hotels, boarding houses, soda fountains, and similar establishments whether served on or off the premises. In the case of American Plan hotels, special packages offered by hotels, e.g., a New Year's Eve package as described in subdivision (a)(1)(E), and boarding houses, a reasonable segregation must be made between the charges for rooms and the charges for the meals, hot prepared food products, and beverages. Charges

by hotels or boarding houses for delivering meals or hot prepared food products to, or serving them in, the rooms of guests are includable in the measure of tax on the sales of the meals or hot prepared food products whether or not the charges are separately stated. (Caterers, see (h) below.) Sales of meals or hot prepared food products by restaurants, concessionaires, hotels, boarding houses, soda fountains, and similar establishments to persons such as event planners, party coordinators, or fundraisers, which buy and sell on their own account, are sales for resale for which a resale certificate may be accepted (see subdivision (h)(3)(C)2.).

Soufflé cups, straws, paper napkins, toothpicks and like items that are not of a reusable character which are furnished with meals or hot prepared food products are sold with the meals or hot prepared food products. Sales of such items for such purpose to persons engaged in the business of selling meals or hot prepared food products are, accordingly, sales for resale.

(B) Complimentary Food and Beverages. Lodging establishments which furnish, prepare, or serve complimentary food and beverages to guests in connection with the rental of rooms are consumers and not retailers of such food and beverages when the retail value of the complimentary food and beverages is "incidental" to the room rental service regardless of where within the hotel premises the complimentary food and beverages are served. For complimentary food and beverages to qualify as "incidental" for the current calendar year, the average retail value of the complimentary food and beverages (ARV) furnished for the preceding calendar year must be equal to or less than 10% of the average daily rate (ADR) for that year.

If a hotel provides guests with coupons or similar documents which may be exchanged for complimentary food and beverages in an area of the hotel where food and beverages are sold on a regular basis to the general public (e.g., a restaurant), the hotel will be considered the consumer and not the retailer of such food and beverages if the coupons or similar documents are non-transferable and the guest is specifically identified by name. If the coupons or similar documents are transferable or the guest is not specifically identified, food and beverages provided will be considered sold to the guest at the fair retail value of similar food and beverages sold to the general public. In the case of coupons redeemed by guests at restaurants not operated by the lodging establishment, the hotel will be considered the consumer of food and beverages provided to the hotel's guests and tax will apply to the charge by the restaurant to the hotel.

Lodging establishments are retailers of food and beverages which do not qualify as "incidental" and tax applies as provided in subdivision (a)(2)(A) above. Amounts paid by guests for food and beverages in excess of a complimentary allowance are gross receipts subject to the tax. Lodging establishments are retailers of otherwise complimentary food and beverages sold to non-guests.

In the case of hotels with concierge floor, club level or similar programs, the formula set forth above shall be applied separately with respect to the complimentary food and beverages furnished to guests who participate in the concierge, club or similar program. That is, the concierge, club or similar program will be deemed to be an independent hotel separate and apart from the hotel in which it is operated. The ADR and the retail value of complimentary food and beverages per occupied room will be computed separately with respect to the guest room accommodations entitled to the privileges and amenities involved in the concierge, club or similar program.

The following example illustrates the steps in determining whether the food and beverages are complimentary:

FORMULA: $ARV \div ADR \leq 10\%$

Average Daily Rate (ADR):

Room Revenue	\$9,108,000
Rooms Rented	74,607
ADR (\$9,108,000 ÷ 74,607)	\$122.08

Average Retail Value of Complimentary

Food and Beverages (ARV):

Complimentary Food Cost	\$169,057
Complimentary Beverage Cost	52,513
Total	\$221,570
Add 100% Markup	221,570
Average Retail Value	\$443,140
ARV per occupied room (\$443,140 ÷ 74,607)	\$5.94

Application of Formula: $\$5.94 \div \$122.08 = 4.87\%$

In the above example, the average retail value of the complimentary food and beverages per occupied room for the preceding calendar year is equal to or less than 10% of the average daily rate. Therefore, under the provisions of this subdivision (a)(2)(B), the complimentary food and beverages provided to guests for the current calendar year qualify as "incidental". The lodging establishment is the consumer and not the retailer of such food and beverages. This computation must be made annually.

When a lodging establishment consists of more than one location, the operations of each location will be considered separately in determining if that location's complimentary food and beverages qualify as incidental.

(b) "DRIVE-INS." Tax applies to sales of food products ordinarily sold for immediate consumption on or near a location at which parking facilities are provided primarily for the use of patrons in consuming the products purchased at the "drive-in" establishment, even though such products are sold on a "take out" or "to go" order and are actually packaged or wrapped and taken from the premises of the retailer. Food products when sold in bulk, i.e., in quantities or in a form not suitable for consumption on the retailer's premises, are not regarded as ordinarily sold for immediate consumption on or near the location at which parking facilities are provided by the retailer. Accordingly, with the exception of sales of hot prepared food products (see (e) below) and sales of cold food under the 80-80 rule (see (c) below), sales of ice cream, doughnuts, and other individual food items in quantities obviously not intended for consumption on the retailer's premises, without eating utensils, trays or dishes and not consumed on the retailer's premises, are exempt from tax. Any retailer claiming a deduction on account of food sales of this type must support the deduction by complete and detailed records.¹

(c) COLD FOOD SOLD ON A "TAKE-OUT" ORDER.

(1) GENERAL.

(A) Seller Meeting Criteria of 80-80 Rule. When a seller meets both criteria of the 80-80 rule as explained in subdivision (c)(3) below, tax applies to sales of cold food products (including sales for a separate price of hot bakery goods and hot beverages such as coffee) in a form suitable for consumption on the seller's premises even though such food products are sold on a "take-out" or "to go" order. Sales of cold food products which are suitable for consumption on the seller's premises are subject to the tax no matter how great the quantity purchased, e.g., 40 one-half pint containers of milk. Except as provided elsewhere in this regulation, tax does not apply to sales of food products which are furnished in a form not suitable for consumption on the seller's premises.

Operative April 1, 1996, although a seller may meet both criteria of the 80-80 rule, he or she may elect to separately account for the sale of "take-out" or "to go" orders of cold food products which are in a form suitable for consumption

¹The records acceptable in support of such a deduction are:

(a) A sales ticket prepared for each transaction claimed as being tax exempt showing:

- (1) Date of the sale,
- (2) The kind of merchandise sold,
- (3) The quantity of each kind of merchandise sold,
- (4) The price of each kind of merchandise sold,
- (5) The total price of merchandise sold,
- (6) A statement to the effect that the merchandise purchased is not to be consumed on or near the location at which parking facilities are provided by the retailer, and

(b) A daily sales record kept in sufficient detail to permit verification by audit that all gross receipts from sales have been accounted for and that all sales claimed as being tax exempt are included therein.

on the seller's premises. The gross receipts from the sale of those food products shall be exempt from the tax provided the seller keeps a separate accounting of these transactions in his or her records. Tax will remain applicable to the sale of food products as provided in subdivisions (a), (b), (e), or (f) of this regulation. Failure to maintain the required separate accounting and documentation claimed as exempt under this subdivision will revoke the seller's election under this subdivision.

(B) Seller Not Meeting Criteria of 80-80 Rule. When a seller does not meet both criteria of the 80-80 rule as explained in subdivision (c)(3) below, tax does not apply to sales of cold food products (including sales for a separate price of hot bakery goods and hot beverages such as coffee) when sold on a "take-out" or "to go" order.

(2) DEFINITIONS.

(A) For purposes of this subdivision (c), the term "suitable for consumption on the seller's premises" means food products furnished:

1. In a form which requires no further processing by the purchaser, including but not limited to cooking, heating, thawing, or slicing, and

2. In a size which ordinarily may be immediately consumed by one person such as a large milk shake, a pint of ice cream, a pint of milk, or a slice of pie. Cold food products (excluding milk shakes and similar milk products) furnished in containers larger in size than a pint are considered to be in a form not suitable for immediate consumption.

Pieces of candy sold in bulk quantities of one pound or greater are deemed to be sold in a form not suitable for consumption on the seller's premises.

The term does not include cold food products which obviously would not be consumed on the premises of the seller, e.g., a cold party tray or a whole cold chicken.

(B) For purposes of this subdivision (c), the term "seller's premises" means the individual location at which a sale takes place rather than the aggregate of all locations of the seller. For example, if a seller operates several drive-in and fast food restaurants, the operations of each location stand alone and are considered separately in determining if the sales of food products at each location meet the criteria of the 80-80 rule.

When two or more food-selling activities are conducted by the same person at the same location, the operations of all food related activities will be considered in determining if the sales of food products meet the criteria of the 80-80 rule. For example, if a seller operates a grocery store and a restaurant with no physical separation other than separate cash registers, the grocery store operations will be included in determining if the sales of food products meet the criteria of the 80-80 rule. When there is a physical separation where customers of one operation may not pass freely into the other operation, e.g., separate rooms with separate entrances but a common kitchen, each operation will be considered separately for purposes of this subdivision (c).

(3) 80-80 Rule. Tax applies under this subdivision (c) only if the seller meets *both* of the following criteria:

(A) more than 80 percent of the seller's gross receipts are from the sale of food products, and

(B) more than 80 percent of the seller's retail sales of food products are taxable as provided in subdivisions (a), (b), (e), and (f) of this regulation.

Sales of alcoholic beverages, carbonated beverages, or cold food to go not suitable for immediate consumption should not be included in this computation. Any seller meeting both of these criteria and claiming a deduction for the sale of cold food products in a form not suitable for consumption on the seller's premises must support the deduction by complete and detailed records of such sales made.

(d) PLACES WHERE ADMISSION IS CHARGED.

(1) GENERAL. Tax applies to sales of food products when sold within, and for consumption within, a place the entrance to which is subject to an admission charge, during the period when the sales are made, except for national and state parks and monuments, and marinas, campgrounds, and recreational vehicle parks.

(2) DEFINITIONS.

(A) "Place" means an area the exterior boundaries of which are defined by walls, fences or otherwise in such a manner that the area readily can be recognized and distinguished from adjoining or surrounding property. Examples include buildings, fenced enclosures and areas delimited by posted signs.

(B) "Within a place" means inside the door, gate, turnstile, or other point at which the customer must pay an admission charge or present evidence, such as a ticket, that an admission charge has been paid. Adjacent to, or in close proximity to, a place is not within a place.

(C) "Admission charge" means any consideration required to be paid in money or otherwise for admittance to a place. "Admission charge" does not include:

1. Membership dues in a club or other organization entitling the member to, among other things, entrance to a place maintained by the club or organization, such as a fenced area containing a club house, tennis courts, and a swimming pool. Where a guest is admitted to such a place only when accompanied by or vouched for by a member of the club or organization, any charge made to the guest for use of facilities in the place is not an admission charge.

2. A charge for a student body card entitling the student to, among other things, entrance to a place, such as entrance to a school auditorium at which a dance is held.

3. A charge for the use of facilities within a place to which no entrance charge is made to spectators. For example, green fees paid for the privilege of playing a golf course, a charge made to swimmers for the use of a pool within a place, or a charge made for the use of lanes in a public bowling place.

(D) "National and state parks and monuments" means those which are part of the National Park System or the State Park System. The phrase does not include parks and monuments not within either of those systems, such as city, county, regional, district or private parks.

(3) Presumption That Food Is Sold for Consumption Within a Place.

When food products are sold within a place the entrance to which is subject to an admission charge, it will be presumed, in the absence of evidence to the contrary, that the food products are sold for consumption within the place. Obtaining and retaining evidence in support of the claimed tax exemption is the responsibility of the retailer. Such evidence may consist, for example, of proof that the sales were of canned jams, cake mixes, spices, cooking chocolate, or other items in a form in which it is unlikely that such items would be consumed within the place where sold.

(4) Food Sold to Students. The exemption otherwise granted by Section 6363 does not apply to sales of food products to students when sold within, and for consumption within, a place the entrance to which is subject to an admission charge, and such sales are subject to tax except as provided in (p) of this regulation. For example, when food products are sold by a student organization to students or to both students and nonstudents within a place the entrance to which is subject to an admission charge, such as a place where school athletic events are held, the sales to both students and nonstudents are taxable.

(e) HOT PREPARED FOOD PRODUCTS.

(1) GENERAL. Tax applies to all sales of hot prepared food products unless otherwise exempt. "Hot prepared food products" means those products, items, or components which have been prepared for sale in a heated condition and which are sold at any temperature which is higher than the air temperature of the room or place where they are sold. The mere heating of a food product constitutes preparation of a hot prepared food product, e.g., grilling a sandwich, dipping a sandwich bun in hot gravy, using infra-red lights, steam tables, etc. If the sale is intended to be of a hot food product, such sale is of a hot food product regardless of cooling which incidentally occurs. For example, the sale of a toasted sandwich intended to be in a heated condition when sold, such as a fried ham sandwich on toast, is a sale of a hot prepared food product even though it may have cooled due to delay. On the other hand, the sale of a toasted sandwich which is not intended to be in a heated condition when sold, such as a cold tuna sandwich on toast, is not a sale of a hot prepared food product. When a single price has been established for a combination of hot and cold food items, such as a meal or dinner which includes cold components or side items, tax applies to the entire established price regardless of itemization on the sales check. The inclusion of any hot food product in an otherwise cold combination of food products sold for a single established price, results in the tax applying to the entire

established price, e.g., hot coffee served with a meal consisting of cold food products, when the coffee is included in the established price of the meal. If a single price for the combination of hot and cold food items is listed on a menu, wall sign or is otherwise advertised, a single price has been established. Except as otherwise provided in (b), (c), (d) or (f) of this regulation, or in Regulation 1574, tax does not apply to the sale for a separate price of bakery goods, beverages classed as food products, or cold or frozen food products. Hot bakery goods and hot beverages such as coffee are hot prepared food products but their sale for a separate price is exempt unless taxable as provided in (b), (c), (d) or (f) of this regulation, or in Regulation 1574. Tax does apply if a hot beverage and a bakery product or cold food product are sold as a combination for a single price. Hot soup, bouillon, or consommé is a hot prepared food product, which is not a beverage.

(2) AIR CARRIERS ENGAGED IN INTERSTATE OR FOREIGN COMMERCE. Tax does not apply to the sale, storage, use, or other consumption of hot prepared food products sold by caterers or other vendors to air carriers engaged in interstate or foreign commerce for consumption by passengers on such air carriers, nor to the sale, storage, use, or other consumption of hot prepared food products sold or served to passengers by air carriers engaged in interstate or foreign commerce for consumption by passengers on such air carriers. "Air carriers" are persons or firms in the business of transporting persons or property for hire or compensation, and include both common and contract carriers. "Passengers" do not include crew members. Any caterer or other vendor claiming the exemption must support it with an exemption certificate from the air carrier substantially in the form prescribed in Appendix A of this regulation.

(f) FOOD FOR CONSUMPTION AT FACILITIES PROVIDED BY THE RETAILER. Tax applies to sales of sandwiches, ice cream, and other foods sold in a form for consumption at tables, chairs, or counters or from trays, glasses, dishes, or other tableware provided by the retailer or by a person with whom the retailer contracts to furnish, prepare, or serve food products to others.

A passenger's seat aboard a train, or a spectator's seat at a game, show, or similar event is not a "chair" within the meaning of this regulation. Accordingly, except as otherwise provided in (c), (d), and (e) above, tax does not apply to the sale of cold sandwiches, ice cream, or other food products sold by vendors passing among the passengers or spectators where the food products are not "for consumption at tables, chairs, or counters or from trays, glasses, dishes, or other tableware provided by the retailer."

(g) TIPS, GRATUITIES, AND SERVICE CHARGES.

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

An optional charge designated as a tip, gratuity, or service charge is not subject to tax. A mandatory charge designated as a tip, gratuity, or service charge is included in taxable gross receipts.

(1) OPTIONAL CHARGE.

(A) A charge for 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. If an employer misappropriates payments for these charges, as discussed in subdivision (g)(1)(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 CHARGE.

(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) An amount added by the retailer to the bill or invoice presented to the customer is presumed to be 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 paid by the customer. This presumption may be controverted by documentary evidence showing that the customer specifically requested and authorized the gratuity be added to the amount billed.

(C) Printed statements on menus, brochures or advertisements that tips, gratuities, or service charges will or may be added to the prices of meals, food, or drinks are evidence that the amounts billed by the retailer and paid by customers are mandatory and subject to tax. 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."

(D) Mandatory charges ~~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~~ if such ~~service~~ charges are ~~made in lieu of tips and are~~ paid over by the retailer to employees.

(h) CATERERS.

(1) DEFINITION

The term "caterer" as used in this regulation means a person engaged in the business of serving meals, food, or drinks on the premises of the customer, or on premises supplied by the customer, including premises leased by the customer from a person other than the caterer, but does not include employees hired by the customer by the hour or day.

(2) SALES TO CATERERS.

A caterer generally is considered to be the consumer of tangible personal property normally used in the furnishing and serving of meals, food or drinks, except for separately stated charges by the caterer for the lease of tangible personal property or tangible personal property regarded as being sold with meals, food or drinks such as disposable plates, napkins, utensils, glasses, cups, stemware, place mats, trays, covers and toothpicks.

(3) SALES BY CATERERS.

(A) Caterer as Retailer. Tax applies to the entire charge made by caterers for serving meals, food, and drinks, inclusive of charges for food, the use of dishes, silverware, glasses, chairs, tables, etc., used in connection with serving meals, and for the labor of serving the meals, whether performed by the caterer, the caterer's employees or subcontractors. Tax applies to charges made by caterers for preparing and serving meals and drinks even though the food is not provided by the caterers. Tax applies to charges made by caterers for hot prepared food products as in (e) above whether or not served by the caterers. A caterer who separately states or itemizes charges for the lease of tangible personal property regardless of the use of the property will be deemed to be the lessor of such property. Tax applies in accordance with Regulation 1660 Leases of Tangible Personal Property – In General. Tax does not apply to charges made by caterers for the rental of dishes, silverware, glasses, etc., purchased by the caterer with tax paid on the purchase price if no food is provided or served by the caterers in connection with such rental.

(B) Caterers as Lessors of Property Unrelated to the Serving or Furnishing of Meals, Food, or Drinks by a Caterer.

1. When a caterer who is furnishing or serving meals, food, or drinks also rents or leases from a third party tangible personal property which the caterer does not use himself or herself and the property is not customarily provided or used within the catering industry in connection with the furnishing and serving of food or drinks, such as decorative props related solely to optional entertainment, special lighting for guest speakers, sound or video systems, dance floors, stages, etc., he or she is a lessor of such property. In such instance, tax applies to the lease in accordance with Regulation 1660.

2. When a person who in other instances is a caterer does not furnish or serve any meals, food, or drinks to a customer, but rents or leases from a third party tangible personal property such as dishes, linen, silverware and glasses, etc., for purposes of providing it to his or her customer, he or she is not acting as a caterer within the meaning of this regulation, but solely as a lessor of tangible personal property. In such instances tax applies to the lease in accordance with Regulation 1660.

(C) Caterers Planning, Designing and Coordinating Events.

1. Tax applies to charges by a caterer for event planning, design, coordination, and/or supervision if they are made in connection with the furnishing of meals, food, or drinks for the event. Tax does not apply to separately stated charges for services unrelated to the furnishing and serving of meals, food, or drinks, such as optional entertainment or any staff who do not directly participate in the preparation, furnishing, or serving of meals, food, or drinks, e.g., coat-check clerks, parking attendants, security guards, etc.

2. When a caterer sells meals, food, or drinks, and the serving of them, to other persons such as event planners, party coordinators, or fundraisers, who buy and sell the same on their own account or for their own sake, it is a sale for resale for which the caterer may accept a resale certificate. However, a caterer may only claim the sale as a resale if the caterer obtains a resale certificate in compliance with Regulation 1668. A person is buying or selling for his or her own account, or own sake, when such person has his or her own contract with a customer to sell the meals, food, or drinks to the customer, and is not merely acting on behalf of the caterer.

3. When a caterer sells meals, food or drinks and the serving of them to other persons who charge a fee for their service unrelated to the taxable sale, the separately stated fee is not subject to tax.

(D) Sales of Meals by Caterers to Social Clubs, Fraternal Organizations. Sales of meals to social clubs and fraternal organizations, as those terms are defined in subdivision (i) below, by caterers are sales for resale if such social clubs and fraternal organizations are the retailers of the meals subject to tax under subdivision (i) and give valid resale certificates therefor.

(E) Tips, Gratuities, or Service Charges.

~~An optional tip or gratuity is not subject to tax. A mandatory tip, gratuity, or service charge is included in taxable gross receipts. A tip, gratuity, or service charge negotiated in advance of an event between the caterer and the customer is mandatory even though the amount or percentage is negotiated. A tip, gratuity, or service charge itemized on an invoice or billing by a caterer is not optional even if the invoice or billing itemizes with a notation such as "optional gratuity." A gratuity is optional only if it is voluntarily added by the customer.~~

~~Examples of mandatory tips, gratuities, or service charges include:~~

~~"A 15% gratuity [or service charge] will be added to parties of 8 or more."~~

~~"Suggested gratuity, 15%," itemized on the invoice or bill by the caterer.~~

Tips, gratuities, and service charges are further discussed in subdivision (g).

(4) PREMISES.

GENERAL. Separately stated charges for the lease of premises on which meals, food, or drinks are served, are nontaxable leases of real property. Where a charge for leased premises is a guarantee against a minimum purchase of meals, food or drinks, the charge for the guarantee is gross receipts subject to tax. Where a person contracts to provide both premises and meals, food or drinks, the charge for the meals, food or drinks must be reasonable in order for the charge for the premises to be non taxable.

(5) PRIVATE CHEFS.

A private chef is generally not an employee of the customer, but an independent contractor who pays his or her own social security, federal and state income taxes. Such a private chef, who prepares and serves meals, food and drinks in the home of his or her customer is a caterer under this regulation.

(i) SOCIAL CLUBS AND FRATERNAL ORGANIZATIONS. "Social Clubs and Fraternal Organizations" as used herein include any corporation, partnership, association or group or combination acting as a unit, such as service clubs, lodges, and community, country, and athletic clubs.

The tax applies to receipts from the furnishing of meals, food, and drink by social clubs and fraternal organizations unless furnished: (1) exclusively to members; and also, (2) less frequently than once a week. Both these requirements must be met. If the club or organization furnishes meals, food or drink to nonmembers, all receipts from the furnishing of meals, food or drink are subject to tax whether furnished to members or nonmembers, including

receipts on occasions when furnished exclusively to members. Meals, food or drink paid for by members are considered furnished to them even though consumed by guests who are not members.

(j) STUDENT MEALS.

(1) DEFINITIONS.

(A) "FOOD PRODUCTS". As used herein, the term "food products" as defined in Regulation 1602 (18 CCR 1602) includes food furnished, prepared, or served for consumption at tables, chairs, or counters, or from trays, glasses, dishes, or other tableware provided by the retailer or by a person with whom the retailer contracts to furnish, prepare or serve food to others.

(B) "MEALS". As used herein, the term "meals" includes both food and nonfood products, which are sold to students for an established single price at a time set aside for meals. If a single price for the combination of a nonfood product and a food product is listed on a menu or on a sign, a single price has been established. The term "meals" does not include nonfood products which are sold to students for a separate price and tax applies to the sales of such products. Examples of nonfood products are: carbonated beverages and beer. For the purpose of this regulation, products sold at a time designated as a "nutrition break", "recess", or similar break, will not be considered "meals".

(2) APPLICATION OF TAX.

(A) Sales by Schools, School Districts and Student Organizations. Sales of meals or food products for human consumption to students of a school by public or private schools, school districts, and student organizations, are exempt from tax, except as otherwise provided in (d)(4) above.

(B) Sales by Parent-Teacher Associations. Tax does not apply to the sale of, nor the storage, use or other consumption in this state of, meals and food products for human consumption furnished or served to the students of a school by parent-teacher associations. Parent-teacher associations qualifying under Regulation 1597 as consumers are not retailers of tangible personal property, which they sell. Accordingly, tax does apply to the sale to such associations of nonfood items such as carbonated beverages, containers, straws and napkins.

(C) Sales by Blind Vendors. Tax does not apply to the sale of meals or food products for human consumption to students of a school by any blind person (as defined in section 19153 of the Welfare and Institutions Code) operating a restaurant or vending stand in an educational institution under article 5 of chapter 6 of part 2 of division 10 of the Welfare and Institutions Code, except as otherwise provided in (d)(4) above.

(D) Sales by Caterers. The application of tax to sales by caterers in general is explained in subdivision (h) above. However, tax does not apply to the sale by caterers of meals or food products for human consumption to students of a school, if all the following criteria are met:

- (1) The premises used by the caterer to serve the lunches to the students are used by the school for other purposes, such as sporting events and other school activities, during the remainder of the day;
- (2) The fixtures and equipment used by the caterer are owned and maintained by the school; and
- (3) The students purchasing the meals cannot distinguish the caterer from the employees of the school.

(k) EMPLOYEES' MEALS.

(1) IN GENERAL. Any employer or employee organization that is in the business of selling meals, e.g., a restaurant, hotel, club, or association, must include its receipts from the sales of meals to employees, along with its receipts from sales to other purchasers of meals, in the amount upon which it computes its sales tax liability. An employer or an employee organization selling meals only to employees becomes a retailer of meals and liable for sales tax upon its receipts from sales of meals if it sells meals to an average number of five or more employees during the calendar quarter.

(2) SPECIFIC CHARGE. The tax applies only if a specific charge is made to employees for the meals. Tax does not apply to cash paid an employee in lieu of meals. A specific charge is made for meals if:

- (A)** Employee pays cash for meals consumed.
- (B)** Value of meals is deducted from employee's wages.

- (C) Employee receives meals in lieu of cash to bring compensation up to legal minimum wage.
- (D) Employee has the option to receive cash for meals not consumed.

(3) **NO SPECIFIC CHARGE.** If an employer makes no specific charge for meals consumed by employees, the employer is the consumer of the food products and the non-food products, which are furnished to the employees as a part of the meals.

In the absence of any of the conditions under (k)(2) a specific charge is not made if:

(A) A value is assigned to meals as a means of reporting the fair market value of employees' meals pursuant to state and federal laws or regulations or union contracts.

(B) Employees who do not consume available meals have no recourse on their employer for additional cash wages.

(C) Meals are generally available to employees, but the duties of certain employees exclude them from receiving the meals and are paid cash in lieu thereof.

(4) **MEALS CREDITED TOWARD MINIMUM WAGE.** If an employee receives meals in lieu of cash to bring his or her compensation up to the legal minimum wage, the amount by which the minimum wage exceeds the amount otherwise paid to the employee is includable in the employer's taxable gross receipts up to the value of the meals credited toward the minimum wage.

For example, if the minimum rate for an eight-hour day is \$46.00, and the employee received \$43.90 in cash, and a lunch is received which is credited toward the minimum wage in the maximum allowable amount of \$2.10, the employer has received gross receipts in the amount of \$2.10 for the lunch.

(5) **TAX REIMBURSEMENT.** If a separately stated amount for tax reimbursement is not added to the price of meals sold to employees for which a specific charge is made, the specific charge will be regarded as being a tax-included charge for the meals.

(l) RELIGIOUS ORGANIZATIONS. Tax does not apply to sales of meals and food products for human consumption furnished or served by any religious organization at a social or other gathering conducted by it or under its auspices, if the purpose in furnishing or serving the meals and food products is to obtain revenue for the functions and activities of the organization and the revenue obtained from furnishing or serving the meals and food products is actually used in carrying on such functions and activities. For the purposes of this regulation, "religious organization" means any organization the property of which is exempt from taxation pursuant to subdivision (f) of Section 3 of article XIII of the State Constitution.

(m) INSTITUTIONS. Tax does not apply to the sale of, nor the storage, use, or other consumption in this state of, meals and food products for human consumption furnished or served to and consumed by patients or residents of an "institution" as defined in Regulation 1503. Tax, however, does apply to the sale of meals and food products by an institution to persons other than patients or residents of the institution.

(n) MEAL PROGRAMS FOR LOW-INCOME ELDERLY PERSONS. Tax does not apply to the sale of, and the storage, use or other consumption in this state of, meals and food products for human consumption furnished or served to low-income elderly persons at or below cost by a nonprofit organization or governmental agency under a program funded by this state or the United States for such purposes.

(o) FOOD PRODUCTS, NONALCOHOLIC BEVERAGES AND OTHER TANGIBLE PERSONAL PROPERTY TRANSFERRED BY NONPROFIT YOUTH ORGANIZATIONS. See Regulation 1597 for application of tax on food products, nonalcoholic beverages and other tangible personal property transferred by nonprofit youth organizations.

(p) NONPROFIT PARENT-TEACHER ASSOCIATIONS. Nonprofit parent-teacher associations and equivalent organizations qualifying under Regulation 1597 are consumers and not retailers of tangible personal property, which they sell.

(q) MEALS AND FOOD PRODUCTS SERVED TO CONDOMINIUM RESIDENTS. Tax does not apply to the sale of and the storage, use, or other consumption in this state of meals and food products for human consumption furnished to and consumed by persons 62 years of age or older residing in a condominium and who own equal shares in a common kitchen facility; provided, that the meals and food products are served to such persons on a regular basis.

This exemption is applicable only to sales of meals and food products for human consumption prepared and served at the common kitchen facility of the condominium. Tax applies to sales to persons less than 62 years of age.

(r) "FREE" MEALS. When a restaurant agrees to furnish a "free" meal to a customer who purchases another meal and presents a coupon or card, which the customer previously had purchased directly from the restaurant or through a sales promotional agency having a contract with the restaurant to redeem the coupons or cards, the restaurant is regarded as selling two meals for the price of one, plus any additional compensation from the agency or from its own sales of coupons. Any such additional compensation is a part of its taxable gross receipts for the period in which the meals are served.

Tax applies only to the price of the paid meal plus any such additional compensation.

(s) FOOD STAMP COUPONS. Tax does not apply to tangible personal property, which is eligible to be purchased with federal food stamp coupons acquired pursuant to the Food Stamp Act of 1977 and so purchased. When payment is made in the form of both food stamps and cash, the amount of the food stamp coupons must be applied first to tangible personal property normally subject to the tax, e.g., nonalcoholic carbonated beverages. Retailers are prohibited from adding any amount designated as sales tax, use tax, or sales tax reimbursement to sales of tangible personal property purchased with food stamp coupons. (See paragraph (c) of Regulation 1602.5 for special reporting provisions by grocers.)

(t) HONOR SYSTEM SNACK SALES. An "honor system snack sale" means a system where customers take snacks from a box or tray and pay by depositing money in a container provided by the seller. Snacks sold through such a system may be subject to tax depending upon where the sale takes place. Sales of such snacks are taxable when sold at or near a lunchroom, break room, or other facility that provides tables and chairs, and it is contemplated that the food sold will normally be consumed at such facilities. Honor system snack sales do not include hotel room mini-bars or snack baskets.

DRAFT

Appendix A

California Sales Tax Exemption Certificate
Supporting Exemption Under Section 6359.1

The undersigned certifies that it is an air carrier engaged in interstate or foreign commerce and that the hot prepared food products purchased from _____ will be consumed by passengers on its flights.

The undersigned further certifies that it understands and agrees that if the property purchased under this certificate is used by the purchaser for any purpose other than that specified above, the purchaser shall be liable for sales tax as if it were a retailer making a retail sale of the property at the time of such use, and the sales price of the property to it shall be deemed the gross receipts from such sale.

Date Certificate Given _____

Purchasing Air Carrier _____
(company name)

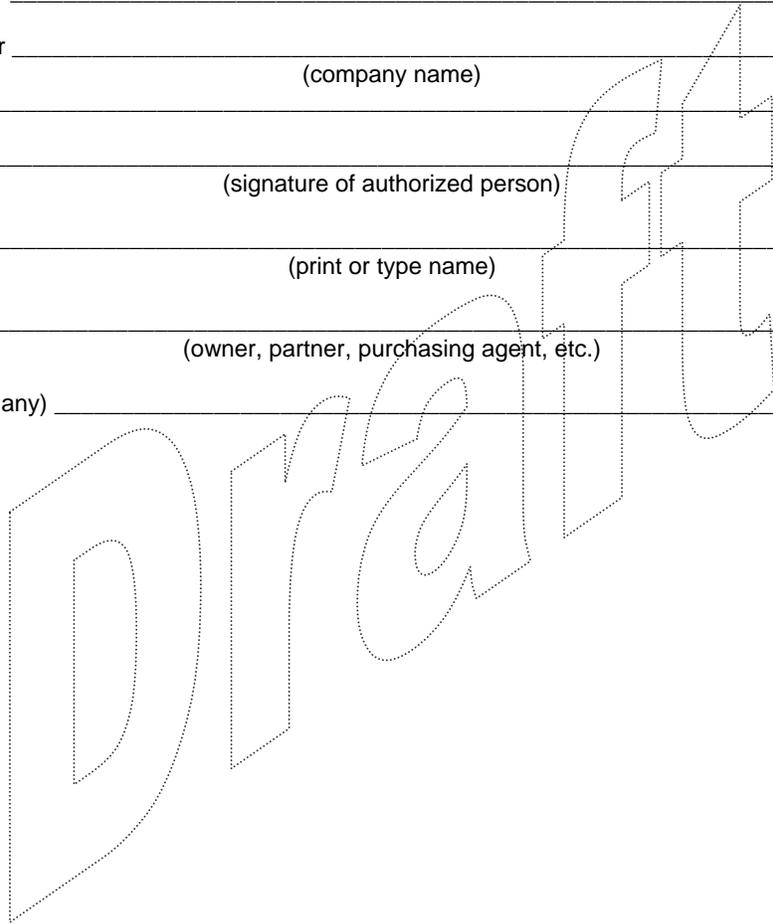
Address _____

Signed By _____
(signature of authorized person)

(print or type name)

Title _____
(owner, partner, purchasing agent, etc.)

Seller's Permit No. (if any) _____



Regulation 1603, *Taxable Sales of Food Products*

...

(g) TIPS AND GRATUITIES~~SERVICE CHARGES~~. 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.

Amounts designated as service charges, negotiated in advance of an event between the caterer and the customer, and 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 employees.~~

(h) CATERERS.

(1) DEFINITION. The term "caterer" as used in this regulation means a person engaged in the business of serving meals, food, or drinks on the premises of the customer, or on premises supplied by the customer, including premises leased by the customer from a person other than the caterer, but does not include employees hired by the customer by the hour or day.

(2) SALES TO CATERERS. A caterer generally is considered to be the consumer of tangible personal property normally used in the furnishing and serving of meals, food or drinks, except for separately stated charges by the caterer for the lease of tangible personal property or tangible personal property regarded as being sold with meals, food or drinks such as disposable plates, napkins, utensils, glasses, cups, stemware, place mats, trays, covers and toothpicks.

(3) SALES BY CATERERS.

(A) Caterer as Retailer. Tax applies to the entire charge made by caterers for serving meals, food, and drinks, inclusive of charges for food, the use of dishes, silverware, glasses, chairs, tables, etc., used in connection with serving meals, and for the labor of serving the meals, whether performed by the caterer, the caterer's employees or subcontractors. Tax applies to charges made by caterers for preparing and serving meals and drinks even though the food is not provided by the caterers. Tax applies to charges made by caterers for hot prepared food products as in (e) above whether or not served by the caterers. A caterer who separately states or itemizes charges for the lease of tangible personal property regardless of the use of the property will be deemed to be the lessor of such property. Tax applies in accordance with Regulation 1660 Leases of Tangible Personal Property – In General. Tax does not apply to charges made by caterers for the rental of dishes, silverware, glasses, etc., purchased by the caterer with tax paid on the purchase price if no food is provided or served by the caterers in connection with such rental.

(B) Caterers as Lessors of Property Unrelated to the Serving or Furnishing of Meals, Food, or Drinks by a Caterer.

1 When a caterer who is furnishing or serving meals, food, or drinks also rents or leases from a third party tangible personal property which the caterer does not use himself or herself and the property is not customarily provided or used within the catering industry in connection with the furnishing and serving of food or drinks, such as decorative props related solely to optional entertainment, special lighting for guest speakers, sound or video systems, dance floors, stages, etc., he or she is a lessor of such property. In such instance, tax applies to the lease in accordance with Regulation 1660.

2. When a person who in other instances is a caterer does not furnish or serve any meals, food, or drinks to a customer, but rents or leases from a third party tangible personal property such as dishes, linen, silverware and glasses, etc., for purposes of providing it to his or her customer, he or she is not acting as a caterer within the meaning of this regulation, but solely as a lessor of tangible personal property. In such instances tax applies to the lease in accordance with Regulation 1660.

(C) Caterers Planning, Designing and Coordinating Events.

2 Tax applies to charges by a caterer for event planning, design, coordination, and/or supervision if they are made in connection with the furnishing of meals, food, or drinks for the event. Tax does not apply to separately stated charges for services unrelated to the furnishing and serving of meals, food, or drinks, such as optional entertainment or any staff who do not directly participate in the preparation, furnishing, or serving of meals, food, or drinks, e.g., coat-check clerks, parking attendants, security guards, etc.

3 When a caterer sells meals, food, or drinks, and the serving of them, to other persons such as event planners, party coordinators, or fundraisers, who buy and sell the same on their own account or for their own sake, it is a sale for resale for which the caterer may accept a resale certificate. However, a caterer may only

claim the sale as a resale if the caterer obtains a resale certificate in compliance with Regulation 1668. A person is buying or selling for his or her own account, or own sake, when such person has his or her own contract with a customer to sell the meals, food, or drinks to the customer, and is not merely acting on behalf of the caterer.

4 When a caterer sells meals, food or drinks and the serving of them to other persons who charge a fee for their service unrelated to the taxable sale, the separately stated fee is not subject to tax.

(D) Sales of Meals by Caterers to Social Clubs, Fraternal Organizations. Sales of meals to social clubs and fraternal organizations, as those terms are defined in subdivision (i) below, by caterers are sales for resale if such social clubs and fraternal organizations are the retailers of the meals subject to tax under subdivision (i) and give valid resale certificates therefor.

(E) ~~Tips, Gratuities, or Service Charges.~~ An optional tip or gratuity is not subject to tax. A mandatory ~~tip, gratuity, or~~ service charge is included in taxable gross receipts. A ~~tip, gratuity, or~~ service charge negotiated in advance of an event between the caterer and the customer is mandatory even though the amount or percentage is negotiated. ~~A tip, gratuity, or service charge itemized on an invoice or billing by a caterer is not optional even if the invoice or billing itemizes with a notation such as "optional gratuity."~~ A gratuity is optional only if it is voluntarily added by the customer.

~~Examples of mandatory tips, gratuities, or service charges include:~~

~~"A 15% gratuity [or service charge] will be added to parties of 8 or more."~~

~~"Suggested gratuity 15%," itemized on the invoice or bill by the caterer.~~

~~Tips, gratuities, and service charges are further discussed in subdivision (g).~~



August 4, 2006

To: Board of Equalization Business Taxes Committee

From: Lara Diaz Dunbar, Vice President, Government Affairs & Public Policy
California Restaurant Association

Kerry Lee, Senior Legislative Director
California Restaurant Association

Subject: Proposed Revisions to Regulation 1603
Interested Parties Response to Second Discussion Paper

In response to the 2nd interested parties meeting held on July 20, 2006, the California Restaurant Association (CRA) would like to register the following comments regarding the restaurant industry's concerns with issues surrounding the current application of tax to charges for mandatory and optional gratuities, as well as the proposed revisions to Regulation 1603. In addition to the below comments, we still assert and maintain our position and comments as expressed in our Interested Parties Proposal dated April 25, 2006 and previously submitted to the BOE staff for consideration *[attached as page 5-10]*.

The June 1st and July 20th meetings were valuable in clarifying the perspectives of all interested parties and facilitating dialogue regarding possible solutions. However, as expressed during the meetings, the CRA does not support the committee proposals included in the initial discussion paper (Item D) and the second discussion paper (Item B) because they would not resolve the inconsistency between state law, which requires that any amount left by a restaurant customer as a tip or gratuity become the property of the employees of the restaurant, and the existing regulation, which presumes such tips are property of the employer and part of their gross receipts and forces restaurateurs to pay taxes on employees' tips and gratuities in certain circumstances.

The CRA maintains there is no basis for a Board of Equalization regulatory policy or audit procedure that results in the imposition of a retail sales tax on the property of the employees of the restaurant. We conclude that no amount of tips or gratuities that belong to the employees and are passed on to the employees in compliance with Labor Code Section 351 should be included in the taxable measure of gross receipts for purposes of calculating the sales tax.

The CRA believes that the authority of an agency to adopt regulations is limited by the enabling legislation. According to the California Government Code, an administrative regulation must be within the scope of authority conferred and in accordance with standards prescribed by other provisions of law and also that no regulation adopted is valid or effective unless consistent and not in conflict with the statute and reasonably necessary to effectuate the purpose of the statute. We believe that statute and case law are clear in that regulations may not be contrary to the interests and purpose of the statute and that any regulation which impairs the scope of a statute should be declared void.

Regulation 1603 (g), the relevant provision to this discussion, has long had Labor Code section 351 expressly stated in the first line of regulation 1603(g). Therefore, the regulation should be within the scope of Labor Code section 351 and be in-line with its intent and purpose. According to current statute and case law, the regulation cannot be outside the scope of Labor Code 351 and cannot impair the scope or be contrary to it. The CRA believes

that the test and standards the BOE is applying in regard to taxation of what they have labeled as "mandatory" tips is contrary to Labor Code 351. The BOE treatment of tips is contrary to the law which states that tips are the property of the employee. Instead, the BOE presumes in certain cases, that tips under Labor Code 351, are not property of the employee, but rather part of the employers' gross receipts and belong to the employer. This is contrary to Labor Code 351, both the black letter law and the intent and scope of the statute. The regulation is forcing tips to become property of the employer in certain circumstances. This is contrary to the governing statute.

Further, in both Discussion Papers, the Board staff cites the case of *Rihn v. Franchise Tax Board* and applies that case to support their position. However, the CRA believes that the case is being misapplied and that the court dictum is being misconstrued and taken out of context by the BOE staff legal analysis.

The *Rihn v. Franchise Tax Board* case is a case where the sole question was whether a waiter's tips could be taxed as income under Personal Income Tax Law. The plaintiff in this case was a waiter and asserted that his tips were not taxable as personal income tax. The court held that tips are in fact part of the compensation to the employee – part of his wages – and thus taxable income. This was the sole issue and holding of the case. The court's ruling in the *Rihn* case is contrary to the BOE's assertion that tips are part of the employer's gross receipts and not property of the employee. If tips are gross receipts for the employer, it could not be tip wages for the employee.

Importantly, contrary to the BOE staff's assertion, this case does not talk about reclassifying the tips from Labor Code 351 tips to gross receipts and does not provide that Labor Code 351 tips can be taxed as gross receipts. In fact, the case holding supports the opposite. Both BOE staff discussion papers inappropriately misstates a part of the court's discussion and dictum as the court's ruling. The court in the case discussed a different issue and did not assert (nor can it be reasonably interpreted to mean) that the Board can treat tips as gross receipts when they are not.



DATE: APRIL 25, 2006

TO: BOARD OF EQUALIZATION BUSINESS TAXES COMMITTEE

FROM: LARA DIAZ DUNBAR
VICE PRESIDENT, GOVERNMENT AFFAIRS & PUBLIC POLICY

SUBJECT: PROPOSED REVISIONS TO REGULATION 1603, TAXABLE SALES OF FOOD PRODUCTS,
REGARDING THE APPLICATION OF TAX TO CHARGES FOR MANDATORY AND OPTIONAL
GRATUITIES

INTERESTED PARTIES PROPOSAL FOR BUSINESS TAXES COMMITTEE
1ST INTERESTED PARTIES MEETING – JUNE 1, 2006

ISSUE

Whether the amount of tips and gratuities which are left by restaurant customers and which, according to California Labor Code Section 351, are the sole property of the employees of the restaurant, should be included in the taxable measure of gross receipts for purposes of the application of sales tax.

CONCLUSION

State law requires that any amount left by a restaurant customer as a tip or gratuity becomes the property of the employees of the restaurant. There is no basis in law for a Board of Equalization (Board) regulatory policy or audit procedure that results in the imposition of a retail sales tax on the property of the employees of the restaurant. We conclude that no amount of tips or gratuities which belong to the employees and is passed on to the employees in compliance with Labor Code Section 351 should be included in the taxable measure of gross receipts for purposes of calculating the sales tax.

BACKGROUND

Recently, restaurant owners around California have been experiencing a more aggressive policy by Board of Equalization (Board) auditors on the issue of “voluntary” versus “mandatory” tips and gratuities left by dining room patrons. When the audits are completed, these owners have been presented with bills for unpaid sales tax (Notices of Determination) amounting to thousands of dollars per restaurant. Of course, by the time the audits are complete it is impossible to collect from the customers and the restaurant owners are forced to pay these tax bills out of their own pockets.

Historically, the Board has taken the position that “voluntary” tips are not subject to sales tax and “mandatory” tips are taxed. Board auditors have taken the position that almost any statement by the restaurant owner with regard to tipping shifts the psychology of the customer from a purely voluntary frame of mind to a feeling of being obligated to leave a tip – thus, making the tip non-voluntary and, therefore, taxable.

With regard to the Board audits, the problem arises, generally, in the case of tips left by large dining room parties. Often, a restaurant owner will, as a protection for his employees, print a statement on the menu to the extent that “An X% Gratuity/Tip May/Will be Added to the Bill for Parties Larger Than Y Individuals.” Board auditors have claimed that this statement “obligates” the customer to pay a tip and makes the tip subject to sales tax.

We believe these distinctions are made moot by the fact that tips are the property of the employees of the restaurant and, as such, are not subject to a sales tax imposed on the restaurant owner by the Board.

State Labor Code section 351 clearly provides that *any* amount of tip/gratuity left by patrons is the property of the employees for whom the gratuity was left and *no portion* may be kept by the restaurant owner for any reason. Further, recent changes in Section 351 strengthen the employees claim on all types of tips, including tips left by means of a credit card.

The amendments to Section 351 specify how restaurant owners and others are to treat tips and gratuities left by credit card. Under new law, for tips left by credit card, employers are not even allowed to deduct credit card processing fees or charges and must pass on to employees 100% of the amount left as gratuities. In addition, the amendments eliminate an exemption from these rules. Old law contained an exemption from this pass-through rule for certain employees with guaranteed wages or salaries. The amendments to Section 351 eliminate this exemption, making *any* tip left for *any* employee subject to the pass-through rule.

In other words, under new law *all* tips left by customers (whether “voluntary” or not) are not the property of the restaurant owner and must be passed on to the employees. We believe the law prevents the Board from imposing on restaurants a retail sales tax on property (i.e., tips and gratuities) that belongs to employees and to which the restaurants have no right whatsoever.

In fact, Board Regulation 1603(g) seems to provide for this same policy. Regulation 1603 provides:

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.

The penalty for violating this prohibition, according to Regulation 1603, is the inclusion of the amount of gratuities kept by the employer in the taxable gross receipts of the restaurant. The regulation leaves the reader with the belief that if the restaurant owner complies with Section 351 and passes 100% of the tips/gratuities on to employees, the tips/gratuities then would NOT be included in taxable gross receipts and would NOT be subject to sales tax.

Board Auditors Continue to Impose Tax on Restaurant Owners

Despite these facts, many Board auditors have pursued a policy that *any* tip is subject to sales tax if the restaurant owner prints a statement in the menu that a tip may/will be added to the bill of parties over a certain size. Board auditors have considered these tips “mandatory” and, therefore, taxable. Even if the patron decides not to leave the recommended amount, Board auditors have pursued the policy that *any* tip that is printed on a credit card receipt, as opposed to handwritten in, is also mandatory no matter the size of the dining party.

But, at least in one audit, a Board auditor opined that a statement on the menu that “An X% Tip May be Added” (emphasis added) was sufficient to show that a tip was voluntary and, therefore, not taxable.

Finally, Board audit policy does not appear to take into account the recent changes in Section 351. Despite the fact that tips left for employees clearly are not the property of the restaurant, Board auditors continue to include tips and gratuities in their calculations of the sales tax base as if these dollars are the property of the restaurant owner.

Board Regulations and Audit Procedures Must be Updated to Reflect Current Law

Restaurant owners are confused by these rules and the inconsistent application of the policy by Board auditors and need clarification so that they may correctly apply the sales tax law and avoid unpaid sales tax bills. Although they know tips and gratuities are the sole property of the employees, they are still being presented with Notices of Determination and required to pay sales tax based on these tips and gratuities.

Sales Tax Would Still Apply to Service Charges Included in Catering Type Contracts That Provide for an All-Inclusive Price for Meals Served

The Board's audit policy appears to have evolved from a regulation (Regulation 1603 (h)) written to apply to caterers – persons who negotiate contracts with their customers to serve meals on the premises of the *customer*. With respect to *caterers*, the regulation exempts a completely voluntary tip from the taxable amount of the catering contract, but taxes a negotiated (i.e., “mandatory”) tip. (Reg.1603(h)(3)(E).)

With regard to *restaurants*, the regulation contains a general rule that “*amounts designated as service charges...must be included in the retailer's gross receipts subject to tax.*” (Reg. 1603(g).)

A Reasonable Policy Toward Taxation of Gratuities

With the recent amendments to Labor Code Section 351 making it clear that ANY AND ALL tips and gratuities belong solely to the employees and cannot be retained by the restaurant owner, we believe it is time for the Board to amend its regulations and audit procedures to reflect the current state of the law. We believe the adoption of the following policy will accurately reflect the restaurant dining room setting and will accurately apply the statutory provisions of the Sales and Use Tax Law:

- The amount of gratuities negotiated prior to a meal and added to the price of the meal should be included in gross receipts subject to tax;

- A gratuity authorized by a restaurant patron whether printed on a credit card receipt or handwritten on a receipt should be excluded from gross receipts subject to tax so long as it is not added to the price of the meal and is merely added to restaurant bill;

See Attached Discussion

DISCUSSION

General Rule:

California imposes a sales tax on retailers for the privilege of selling tangible personal property and the tax is based on a percentage of the gross receipts from the sale of tangible personal property. (Revenue and Taxation Code Section 6051.) A "sale" includes "the furnishing, preparing, or serving for a consideration of food, meals, or drinks." (RTC sec. 6006.) The retailer's "gross receipts" include:

- "the total amount of the sale...of the retail sales of retailers, valued in money, whether received in money or otherwise..."; (RTC sec. 6012(b) and includes
- "any services *that are part of the sale*" (emphasis added) (RTC sec. 6012(b)(1).).

Finally, although the law exempts the sale of "food products for human consumption," the exemption does not apply when the food products are served as meals on or off the premises of the retailer. (RTC sec. 6359.)

Tips and Gratuities:

The Sales and Use Tax Law (Division 2, Part 1 of the Revenue and Taxation Code) provides no statutory guidance on the tax treatment of tips and gratuities. In regulation and audit policy, however, the Board has developed a practice of taxing "mandatory" tips/gratuities and not taxing "voluntary" tips/gratuities.

CATERERS: The Board's policy with regard to the taxation of tips is clearly spelled out for **caterers** in Regulation 1603 *Taxable Sales of Food Products*:

"An optional tip or gratuity is not subject to tax. A mandatory tip, gratuity, or service charge is included in taxable gross receipts." (Regulation 1603(h)(3)(E) Sales by Caterers; Tips, Gratuities, or Services.)

Although a rationale for this policy seems to be lost to history, it appears that the Board's regulatory policy developed around the principal that if the tip is included in the price of the meal served, then the tip is included in taxable gross receipts. (See RTC sec. 6012.) In fact, the regulation above provides "(a) tip, gratuity, or service charge negotiated in advance of an event between the caterer and the customer is mandatory even though the amount or percentage is negotiated." Further, the regulation provides that a tip itemized on a catering invoice or billing is taxable even if the invoice provides that the tip is an "optional gratuity." With regard to the catering customer's say in the matter, the only regulatory guidance is that "a gratuity is 'optional' (and, therefore, non-taxable) only if it is voluntarily added by the customer." (Reg. 1603(h)(3)(E).)

Typically, a catering contract is negotiated between the caterer and customer well in advance of the served meal. The customer agrees to a lump sum price for a served meal including the cost of the meal plus other services and goods such as delivery, service, plates and utensils, tip, gratuity or service charge. Once the negotiations have ended, the customer typically enters into a contract with the caterer and is then contractually bound to pay the set price to the caterer. In this setting, the price of the meal appears to include a tip that, under RTC section 6012, would be included in taxable gross receipts.

RESTAURANTS: The question is does this Board regulatory policy regarding taxation of tips in connection with catering contracts apply to **restaurant owners and their dining room patrons?** Regulation 1603 defines “caterers” as “person(s) engaged in the business of serving meals, food, or drinks *on the premises of the customer.*” (Reg. 1603(h)(1).) Restaurants do not fit this definition as they serve meals to walk-in customers and reservation customers in the restaurant dining room.

So, do restaurants have guidance regarding the taxation of tips provided by dining room patrons? Again, the Sales and Use Tax Law provides no statutory guidance for restaurants. And, as discussed above, restaurants do not fit into the category of “caterer” for purposes of Regulation 1603.

Regulation 1603(g) does provide some general guidance on the treatment of tips and service charges. First, the regulation provides that no employer shall retain a portion of any gratuity or deduct any portion of a gratuity from the wages of an employee. Any violation of this provision results in the inclusion of the amount retained as part of the employers gross receipts and subject to sales tax. This regulation is based on the provisions of Labor Code 351 which clearly provides that gratuities of any kind are the sole property of the employee or employees for whom the customer left the gratuity. A recent amendment to Section 351 provides that gratuities paid by credit card are also the sole property of the employee and must be paid to the employee not later than the next regular payday. No distinction is made between gratuities written in by the customer or amounts authorized by the customer and printed out on the receipt.

Regulation 1603(g) also provides that “service charges, added to the price of meals are a part of the selling price...and...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 ... to employees.”

BOARD PRACTICE: This is the extent of the statutory and regulatory guidance available to restaurant owners. Unfortunately, Board staff has developed a practice of applying the catering rule of distinguishing between “voluntary” and “mandatory” tips and has published this practice as official advice to restaurant owners in Board publications (see Publication 22 - *Tax Tips for the Dining & Beverage Industry: Sales and Use Taxes* and Publication 115 – *Applying Sale Tax to Tips and Related Payments*).

Board auditors have established the practice of including in gross receipts the amount of any tip that is printed on a receipt (typically for a credit card transaction) as opposed to a tip that is handwritten by the customer. In fact, the Board’s Sales and Use Tax Audit Manual reflects this merger of the catering rule with restaurant practice. (See Sales and Use Tax Audit Manual Section 0809.20.) The auditor’s presumption is that a printed amount for a tip is “mandatory” and, therefore subject to tax. Recently, on at least one occasion, a Board auditor simply applied tax to all tips provided to parties of eight or more at a restaurant which had the following notice printed on its menu: “A 17% Gratuity Will be Added for Parties of Eight or More.” The fact that the customer was consulted on each occasion after the meal was served and authorized a gratuity which many times was either higher or lower than the suggested 17% was irrelevant to the auditor.

Board Audit Policy Should Conform to Restaurant Dining Room Practice and Current Law Relating to Employee Ownership of Tips and Gratuities:

We believe the current Board policy is not supported in statute or regulation and we believe the Board’s practice of using the catering rules on taxing tips is inappropriate in the restaurant dining room setting. The policy should be amended to reflect the actual practice of restaurant owners and should recognize the factual distinctions between the dining room setting and a catering operation.

Most importantly, we believe the Board does not have statutory or regulatory authority to impose a retail sales tax on restaurant owners based on tips and gratuities that are the property of the employees.

Restaurant patrons should not be required to pay sales tax on gratuities that are, by California law, not the property of the restaurant owner.

- Labor Code section 351 makes it clear that gratuities are the sole property of the employee. The restaurant owner is merely the conduit for payment of the gratuity to the employee.
- We unable to find authority for the Board to impose a sales tax on property not owned by the restaurant owner.
- Recent amendments to Labor Code section 351 (See Statutes of California, Chapter 876 (AB 2509), Approved by Governor, September 28, 2000.) make it clear that *any* gratuity added to a credit card transaction is the property of the employee or employees of the restaurant and may not be retained by the restaurant owner for any reason. No distinction is made between a handwritten amount for a tip or an amount that is printed on the credit card receipt.
- These amendments also eliminate an exemption previously contained in Section 351. Under old law, an employer could keep tips left for certain salaried employees or deduct the amount of tips left for these employees from their wages. The amendments eliminate this exemption making ALL tips left by customers the property of ANY and ALL employees.
- According to Regulation 1603(g), any amount of a gratuity that is retained by the restaurant owner is to be included in the taxable gross receipts of the restaurant and subjected to tax. Restaurant owners should be concerned with the implication of the inclusion of any gratuity in taxable gross receipts. Auditors have been including “mandatory” gratuities in taxable gross receipts and the question is raised as to whether the restaurant owner is unwittingly admitting guilt even though all amounts of gratuities received by the restaurant owner were promptly transmitted to employees.

Regulation 1603, *Taxable Sales of Food Products*

...

(g) TIPS, GRATUITIES, AND SERVICE CHARGES.

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

(1) An optional amount voluntarily left by a guest or patron (typically characterized as a “tip” or a “gratuity”) is not subject to tax. In contrast, a mandatory charge imposed by the retailer (typically characterized as a “service charge”) is included in taxable gross receipts.

(2) An amount negotiated between a restaurant, hotel, caterer, boarding house, soda foundation, drive-in or similar establishment and the customer in advance of a meal, food, drinks, or an event that includes a meal, food, or drinks is mandatory even though the amount or percentage is negotiated. Thus, language such as “A 15% service charge will be added for parties of 8 or more” will be deemed to be mandatory in nature and included in taxable gross receipts.

(3) An amount itemized on an invoice or billing by a restaurant, hotel, caterer, boarding house, soda foundation, drive-in or similar establishment is not optional but is regarded as mandatory, even if the invoice or billing itemizes it with a notation such as “optional service charge.”

(4) A gratuity is optional only if it is voluntarily added by the customer. Language such as “A suggested gratuity [or amount] of 15% will be added for parties of 8 or more” will be deemed to indicate a voluntary payment by the customer and therefore not included in taxable gross receipts.

(5) 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) 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 employees.

(6) Consistent with the foregoing, there shall be a rebuttable presumption that amounts designated by the retailer as a “service charge” are mandatory in nature, and therefore subject to tax, whereas amounts designated as “tips” or “gratuities” have been voluntarily left by the patrons, and therefore not subject to tax.

(h) **CATERERS.**

(3) SALES BY CATERERS.

~~(E) **Tips, Gratuities, or Service Charges.** An optional tip or gratuity is not subject to tax. A mandatory tip, gratuity, or service charge is included in taxable gross receipts. A tip, gratuity, or service charge negotiated in advance of an event between the caterer and the customer is mandatory even though the amount or percentage is negotiated. A tip, gratuity, or service charge itemized on an invoice or billing by a caterer is not optional even if the invoice or billing itemizes with a notation such as “optional gratuity.” A gratuity is optional only if it is voluntarily added by the customer.~~

Examples of mandatory tips, gratuities, or service charges include:

~~“A 15% gratuity [or service charge] will be added to parties of 8 or more.”~~

~~“Suggested gratuity 15%,” itemized on the invoice or bill by the caterer.~~

Tips, gratuities, and service charges are further discussed in subdivision (g).



MEMORANDUM

TO: Cecilia Watkins

FROM: Jim Abrams

DATE: August 3, 2006

SUBJECT: Regulation 1603
Follow-Up Comments to July 20, 2006 Meeting

The California Hotel & Lodging Association (**CH&LA**) feels that the discussion at the second Interested Parties meeting on July 20 was extremely useful to clarify the respective positions of the various parties.

After reviewing all of the materials and comments that have been considered to date, CH&LA respectfully submits the most significant issue that has arisen pertaining to the application and enforcement of Regulation 1603 pertains to the practice of food service operators adding an amount to a customer's check or bill to deal with the problem of making sure that service personnel receive an appropriate tip when waiting on larger parties. More specifically, when dealing with larger parties (e.g., groups of six or more, eight or more, and the like), retailers often find that there is confusion among the customers in the party as to who is going to leave a tip, how much it should be, whether each customer should leave a tip or let one person deal with the issue. This frequently leads to situations in which an inappropriately small voluntary gratuity is left, which deprives the service personnel of gratuities they would otherwise appropriately receive.

In order to address this problem, many food service operators have resorted to inserting an appropriately sized tip/gratuity into the process by use of such language as "A 15% gratuity will be added for parties of 8 or more." The fact that language such as this is utilized does not change the fact that the amount left by the customers is exactly like, and is intended by the customers to be used as, a typical voluntarily tip/gratuity. That is, the employer/retailer is never claiming any right, title, or interest in or to the money, recognizes that the amount left at all times belongs solely to the employees, as specified in Labor Code Sections 351, et seq., and acts solely as a conduit to transmit the tip/gratuity to the appropriate employees.

The problem vis-à-vis Regulation 1603 arises because the actions of the

employer/retailer *appear* to transmute what is clearly a voluntarily tip/gratuity into some sort of mandatory transaction. This creates the question of whether this amount is taxable or not.

CH&LA certainly understands the need for both BOE auditing staff and the retail food service industry to have clear direction as to when an amount such as this is taxable and when it is not taxable. Unfortunately, some of the “bright line” tests utilized by BOE staff in conducting audits lead to inapt results. CH&LA submits that, in particular, BOE auditors focus too much on whether or not the retailer enters an amount on the customer’s bill or invoice, or whether the language used by the retailer to describe the nature of the transaction implies some sort of mandatory characteristic. The fact of the matter is that transactions of this type involve nothing more than more carefully structured mechanisms to insure that employees get the type of voluntarily gratuities that they deserve in dealing with larger parties.

In recognition of the foregoing, CH&LA proposes that Regulation 1603 be amended to read as submitted herewith. We have taken the draft language that staff submitted at the July 20 meeting as our starting point and we show how we would change that draft. That is the “marked-up” version that is attached. We have also prepared a “clean” version of what we believe is the proper wording in Regulation 1603 to deal with this problem while staying as close as possible to current practice and applicable law.

As always, CH&LA thanks you and your colleagues for your willingness to help find a suitable resolution to this issue.

Attachments (2)

cc: Lara Diaz Dunbar
Kerry Lee
Charles Moll
(w/attachments)

Regulation 1603, *Taxable Sales of Food Products*

...

(g) TIPS, GRATUITIES, AND SERVICE CHARGES.

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

(1) An amount left by a guest or patron for the server (typically characterized as a "tip" or a "gratuity") is not subject to tax. In contrast, a charge imposed by the retailer (typically characterized as a "service charge") is included in taxable gross receipts.

(2) A service charge negotiated between a restaurant, hotel, caterer, boarding house, soda foundation, drive-in or similar establishment and the customer in advance of a meal, food, drinks, or an event that includes a meal, food, or drinks, is included in gross taxable receipts even though the amount or percentage is negotiated. Thus, where a service charge is imposed pursuant to language such as "A 15% service charge will be added for parties of 8 or more" that charge will be included in taxable gross receipts.

(3) A service charge itemized on an invoice or billing by a restaurant, hotel, caterer, boarding house, soda foundation, drive-in or similar establishment is included in taxable gross receipts even if the invoice or billing itemizes it with a notation such as "optional service charge."

(4) A gratuity or a "tip" is an amount left by the customer, typically for the server, including such amounts calculated or physically added to the invoice by the retailer. Language on a menu such as "A suggested gratuity of 15% will be added for parties of 8 or more" will be deemed to indicate a payment by the customer for the server which is not included in taxable gross receipts.

(5) 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) 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 employees.

(6) Consistent with the foregoing, there shall be a rebuttable presumption that amounts designated by the retailer as a "service charge" are consideration paid for the meal and are included in taxable gross receipts, whereas amounts designated as "tips" or "gratuities" left by the patrons are consideration for the server and not for the meal, and therefore are not included in taxable gross receipts.

(h) CATERERS.

(3) SALES BY CATERERS.

~~**(E) Tips, Gratuities, or Service Charges.** An optional tip or gratuity is not subject to tax. A mandatory tip, gratuity, or service charge is included in taxable gross receipts. A tip, gratuity, or service charge negotiated in advance of an event between the caterer and the customer is mandatory even though the amount or percentage is negotiated. A tip, gratuity, or service charge itemized on an invoice or billing by a caterer is not optional even if the invoice or billing itemizes with a notation such as "optional gratuity." A gratuity is optional only if it is voluntarily added by the customer.~~

Examples of mandatory tips, gratuities, or service charges include:

~~"A 15% gratuity [or service charge] will be added to parties of 8 or more."~~

~~"Suggested gratuity 15%," itemized on the invoice or bill by the caterer.~~

Tips, gratuities, and service charges are further discussed in subdivision (g).

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August 4, 2006

Jeffrey L. McGuire
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Re: **Proposed Revisions to Regulation 1603**

Dear Mr. McGuire:

Following the second interested parties meeting, staff solicited comments addressing the new language proposed for Regulation 1603. I am writing this letter to provide comments, both conceptual and on the specific proposed language. Although I understand that other proposals may be forthcoming and will be discussed, my comments herein are limited to the specific language presently proposed for the regulation. Moreover, although I will not repeat them here, I continue to maintain the comments I previously submitted by letter dated June 19, 2006.

First, I believe that conceptually the proposed language improperly focuses upon a "mandatory" tip versus a "voluntary" tip. As I commented in my prior letter, this distinction is not found as a general proposition in the Revenue and Taxation Code, nor in the case law. To the contrary, the Revenue and Taxation Code, and the fundamental principle underlying the sales tax regime, is that the tax is imposed only upon gross receipts from the sale of tangible personal property. Thus, to be consistent with this fundamental principle, an amount paid as a tip, just like any other payment, would be subject to sales tax only if it was a payment for tangible personal property. If the payment is for something other than tangible personal property, it is not subject to sales tax, regardless as to whether that payment is voluntary or mandatory. Consequently, simply identifying whether a payment is "mandatory" as opposed to "voluntary" is not, by itself, a litmus test for deciding whether a payment is for tangible personal property or

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not. This is true for tips, just like it is for any other payment. Accordingly, the focus of the regulation should be upon for what purpose was the tip paid. Was the payment for the food, in which case it is included in the taxable measure, or was it intended as compensation for the server's services, in which case it is not a payment for tangible personal property and thus is not included in the taxable measure.

The provisions of the Revenue and Taxation Code do not specify otherwise. Staff has relied upon one example – extended warranties – where the regulation provides that mandatory warranties are subject to sales tax, but voluntary ones are not, and then staff suggests that this “voluntary” vs. “mandatory” distinction permeates the Code, and therefore also should apply to tips.

However to the contrary, this extrapolation is erroneous. First, that warranty example is a special example and is not a reflection of the general tenor of the Code. Indeed, the sales tax law contains many examples contrary to this “voluntary” vs. “mandatory” distinction. For example, separately stated transportation charges added to an invoice for tangible personal property, are not included in gross receipts, even though payment of that charge is mandatory in order to get the tangible personal property. *See*, Regulation 1628(a) This is because the payment is truly for the transportation, and not for the tangible personal property. The same should be true for tips.

Moreover, payments to a retailer for a mandatory warranty typically is a charge by the retailer, and is included in the retailer's gross receipts. In contrast, tips typically are not the gross receipts of the retailers, but are intended by the patron to be a payment to the server.

Finally, in any event, the food service industry is different from most retailers. Tipping the server in food establishments is a well-established, but somewhat unique custom in the United States. Whereas it is customary for patrons to provide a tip to the server, it is not customary to generally tip retailers of tangible personal property. The staff's proposed regulation fails to recognize this undeniable fact of American society. And certainly, pointing to payments for mandatory warranties as providing support misses the mark for such payments hardly are ingrained in modern society as is tipping one's food server.

Second, the proposed regulation in focusing upon “mandatory” versus “voluntary”, is inconsistent with California case law. In Anders v. SBE, 82 Cal. App. 2d 88 (1947), the Court of Appeal analyzed whether tips were subject to sales tax or not without ever venturing into the “voluntary” versus “mandatory” quagmire. Rather, the Court focused exclusively upon to whom the tips belonged. If by agreement the tips belonged to the restaurant, then they were properly taxable. If, instead, the tips belonged to the plaintiff waitresses, then they were not subject to sales tax. This is consistent with the underlying fundamental premise of the sales tax law that only gross receipts from the sales of tangible personal property are taxable,

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and that labeling the payment as "voluntary" or "mandatory" does not, as a general rule, help define what the gross receipts are for.

Indeed, the very case cited by staff, Rihn v. FTB, 131 Cal. App. 2d 356 (1955), which addressed the issue of whether tips were included in the taxable income of the server, itself cited at least a dozen other cases dealing with tips, including whether the tips were part of the earnings of the employee rather than the employer, whether the tips counted toward the employer's minimum wage entitlements, whether the tips were includable as taxable income by the server, and even whether the tips were subject to sales tax. Significantly, in discussing those issues, nowhere does the Rihn court even mention as a factor, let alone use as a distinguishing and deciding factor, whether the tips were considered to be "mandatory" rather than "voluntary".

In addition to these conceptual concerns about the premise underlying the proposed regulation, I also have additional concerns with the specific proposed language. Even if one were to accept, arguendo, the premise that distinguishing between "mandatory" and "voluntary" tips would be an appropriate distinction to base the sales tax upon, the proposed language is quite overbroad in identifying what constitutes a "mandatory" tip.

For example, the last two sentences of paragraph 1 can be internally inconsistent. They state:

A tip, gratuity or service charge itemized on an invoice or billing by a restaurant, hotel, caterer, boarding house, soda fountain, drive-in or similar establishment is not optional but is regarded as mandatory, even if the invoice or billing itemizes it with a notation such as "optional gratuity." A gratuity is optional only if it is voluntarily added by the customer.

Yet both of those sentences could apply at the same time, leaving the result unclear. For example, in the instance where the patron voluntarily decides on the amount (or percentage) of the tip, and tells the restaurant to itemize that on the final bill, the two sentences would require conflicting results.

Similarly, the examples are overbroad. For example, where a menu says "a 15% gratuity will be added," but the patron selects a different amount to tip (say 12% or 18%) the regulation nevertheless would improperly convert what is truly a voluntary payment into a supposedly mandatory one.

Likewise, where the restaurant has language merely suggesting a 15% gratuity, but where the ultimate decision as to what tip, if any, should be given is left to the patron, again the regulation treats this voluntary tip as a mandatory, taxable payment.

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Finally, nowhere in the regulation is there any provision allowing the taxpayer to prove that some or all of the tips paid in its restaurant were voluntary. Taxpayers should be not be deprived of this opportunity to come before the Board to attempt to prove their case, particularly on an issue, like this, that is inherently factual.

Respectfully submitted,



Charles J Moll III

CJM/ele

MEMORANDUM

TO: California State Board of Equalization Business Taxes Committee

FROM: Charles J. Moll III

DATE: June 19, 2006

RE: Proposed Revisions to Regulation 1603, Taxable Sales of Food Products,
Regarding the Application of Sales Tax to Charges for Gratuities

Interested Parties Submission in Response to 5/12/06 Initial Discussion Paper
and 6/1/06 Interested Parties Meeting

On May 12, 2006, the Board of Equalization's (BOE) Tax Policy Division, Sales and Use Tax Department, issued an Initial Discussion Paper discussing whether Regulation 1603, Taxable Sales of Food Products, should "be amended to clarify the application of tax to charges for mandatory and optional gratuities." On June 1, 2006, an interested parties meeting was held to discuss the issue. This interested parties memorandum submission addresses the primary issue in the BOE's Initial Discussion Paper and some of the comments and concerns raised during the June 1st interested parties meeting.

I. INTRODUCTION

Under Regulation 1603, the BOE currently makes a distinction between "mandatory" and "optional" gratuities for purposes of determining the correct amount of gross receipts subject to sales tax. The BOE's current policy is to treat a gratuity added to the bill by the retailer as mandatory, even when a statement on the menu or bill indicates the gratuity is optional. However, gratuities that are left by customers on their own volition are treated by the BOE as voluntary and therefore nontaxable.

The issue facing many restaurant owners is not limited to the narrow issue of whether gratuities automatically added by the restaurant to customers' checks are optional where a menu notice indicates that the gratuities are voluntary but will be added to the checks. Instead, the much broader and more pressing issue is whether gratuities, mandatory or optional, received by restaurant employees should be subject to sales tax under the applicable statutory provisions. This is the issue addressed below.

II. DISCUSSION

California imposes sales tax upon all retailers "[f]or the privilege of selling tangible personal property." (Rev. & Tax. Code § 6051.) The tax is imposed on "the gross receipts ... from the sale of all tangible personal property sold at retail in this state." (*Id.*) A "retail sale" means a "sale for any purpose other than resale in the regular course of business in the form

of tangible personal property.” (Rev. & Tax. Code § 6007.) The term “gross receipts” is defined in Revenue and Taxation Code Section * 6012. Section 6012 states in pertinent part:

(a) ‘Gross receipts’ mean the total amount of the sale or lease or rental price, as the case may be, of the retail sales of retailers, valued in money, whether received in money or otherwise, without any deduction on account of any of the following:

- (1) The cost of the property sold....
- (2) The cost of the materials used, labor or service cost, interest paid, losses, or any other expense.

(Rev. & Tax. Code § 6012(a).)

A. Are Gratuities Included in the “Sale Price”?

At the June 1st interested parties meeting, there were several comments by BOE staff members to the effect that an optional gratuity is not part of the “sale price” for purposes of determining gross receipts under Section 6012, but that a mandatory gratuity is part of the “sale price” for purposes of determining gross receipts under Section 6012. This distinction finds no basis in the applicable statutory provisions; rather in either case the gratuity should not be included in the “sale price.” Under the plain meaning of the words in the statute, a gratuity received by a restaurant employee, regardless of whether the gratuity is optional or mandatory, is for the employee’s service and not for “tangible personal property”, and thus must not be included in the “gross receipts” of the restaurant’s retail sale.

First, obviously the service provided by a restaurant employee while serving the customer a meal is not a sale of tangible personal property. Rather, this is a service in its most pure and simple form and any gratuity, mandatory or optional, received for such service should not be subject to sales tax. (See Rev. & Tax. Code §§ 6007, 6051.)

Second, Section 6012 makes no distinction between “mandatory” and “optional” service charges. This is a fiction created by Regulation 1603 that finds no basis in the statutory language.

Third, gratuities, mandatory or optional, are not required to be included in the “sale price” under Section 6012. The term “service” as used in Section 6012 does not contemplate the “service” being provided by a restaurant employee to the restaurant’s customers. Section 6012 states there shall be no deduction from the sale price for the “cost of the materials used, labor or service cost, interest paid, losses, or any other expense.” (Emphasis added.) If the term “service” as used in the statute was meant to include the “service” provided by a restaurant employee to the restaurant’s customers, then all gratuities, mandatory or optional, would be part of the “sale price” and included in gross receipts for purposes of computing the sales tax. Instead, the term “service” as used in Section 6012 contemplates expenses

* All statutory references herein are to the Revenue and Taxation Code, unless otherwise noted.

incurred by the retailer as part of the sale of tangible personal property which must be included in the “sale price.” This interpretation is expressly supported by subsection (a)(2) of Section 6012 which states there shall be no deduction from the sale price for “labor or service cost ... or any other expense.” “Service cost” is just one example in the statute of an expense incurred by the retailer that cannot be deducted from the “sale price.” A gratuity, mandatory or optional, does not represent an expense, or even a reimbursement of an expense otherwise payable by the restaurant, that is being passed on to the customer.*

The term “expense” is not defined in the Sales and Use Tax Law for purposes of Section 6012. However, in the operation of a business, “expense” is generally a financial accounting term used to describe “outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity’s ongoing major or central operations.” (FASB, Statement of Financial Accounting Concepts, No. 6, ¶ 80 (1985).) A gratuity, mandatory or optional, is not an “expense” of the restaurant by any stretch of the imagination, but by well-established tradition in United States society is a payment by the customer to the employee for the service performed. Indeed all gratuities, mandatory or optional, given by restaurant customers are the sole property of the employees of the restaurant under California law. (See Labor Code § 351.) This means a gratuity, mandatory or optional, cannot represent reimbursement of an expense of the restaurant that is used to defray the cost of its food sale. In other words, a gratuity, mandatory or optional, given by a restaurant’s customer for the service provided by the restaurant’s employee is not and cannot be a “service cost” or expense within the meaning of Section 6012.

Accordingly, the applicable statutory provisions do not support a distinction between mandatory and optional gratuities. Moreover, there is no language in Section 6012 that either (1) requires gratuities, mandatory or optional, be included in the sale price of the meal; or (2) prevents all gratuities received by restaurant employees from being excluded from the sale price of the meal.

B. Are Gratuities “Gross Receipts” of the Restaurant?

One of the principle contentions raised by the California Restaurant Association during the June 1st interested parties meeting was that gratuities cannot not be considered part of the gross receipts from the sale of tangible personal property because the gratuities are not the property of the restaurant owner. Labor Code Section 351 provides that *any* amount of gratuity “paid, given to, or left” by patrons is the “sole property” of the restaurant employees. Section 351 states in full:

* Where the restaurant has guaranteed a specific hourly rate to the employee, whereby the tips received are used to satisfy the restaurant’s obligation to the employee, then in that case the customer’s tips properly would be viewed as defraying an expense of the restaurant, and should be included in the taxable amount of the sale to the extent that the tip amount plus any amounts paid by the restaurant do not exceed the guaranteed amount. *C. Anders et al. v. State Board of Equalization* (1947) 82 Cal.App.2d 88. Tips in excess of the guaranteed wages would not be considered as belonging to the restaurant, and thus would not be taxable. *Id.*

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. *Every gratuity is hereby declared to be the sole property of the employee or employees to whom it was paid, given, or left for.* An employer that permits patrons to pay gratuities by credit card shall pay the employees the full amount of the gratuity that the patron indicated on the credit card slip, without any deductions for any credit card payment processing fees or costs that may be charged to the employer by the credit card company. Payment of gratuities made by patrons using credit cards shall be made to the employees not later than the next regular payday following the date the patron authorized the credit card payment.

(Labor Code § 351, emphasis added.)

Several comments were made by BOE staff during the June 1st interested parties meeting to the effect that ownership of the gratuities is not a consideration for purposes of determining whether the gratuities are gross receipts under Section 6012. One specific comment was that when a gratuity is mandatory, it is collected at the same time as the price for the meal and is part of the gross receipts for the sale under Section 6012, notwithstanding the fact the gratuity is the property of the employee. Another similar comment was that the ownership provisions of Labor Code Section 351 should have no bearing whatsoever on whether gratuities are part of the gross receipts for the sale. These comments find no support under the case law.

In 1947, the California Court of Appeal in *C. Anders v. SBE, supra*, addressed the issue of whether certain tips received by restaurant employees should be subject to sales tax. The “gross receipts” statute examined in *Anders* was substantively similar to the current “gross receipts” language in Section 6012.

In that case, by contractual agreement, the restaurant and employees had agreed that the restaurant would guarantee to the employee that if the tips did not equal the required state minimum wages, then the restaurant would pay the employees the difference. The issue examined by the Court was whether the tips received by the employees became part of the gross receipts of the employer for sales tax purposes. (*Anders* at 91.)

In deciding the issue, the Court expressly analyzed to whom the tips belonged. The Court noted that in the absence of an explicit contrary understanding, tips would belong to the recipient employee. However, the Court further observed that, as in the case before it, in certain circumstances by contract between the parties the tips could become the property of the restaurant. Thus, the Court held the “tips received by the [employees], to the extent of

the minimum wages provided by law,” became part of the restaurants’ “gross receipts for services in connection with their sales of tangible personal property.” (*Id.* at 92.)

Accordingly, the fact the tips became the property of the restaurants was the single controlling factor in *Anders* for purposes of determining whether the gratuities in issue should be part of the restaurants’ gross receipts from sales of tangible personal property. In contrast, the Court concluded that the balance of all tips received by the employees over and above the amount of minimum wages “belonged to [the employees], and the Board of Equalization properly disregarded them in levying the taxes.” (*Anders* at 93.)

Based on the foregoing, the BOE should consider who owns the gratuity -- not whether it is mandatory or optional -- for purposes of determining whether the gratuity constitutes gross receipts that are part of the sale.

C. Regulation 1603 Requires Adherence to Labor Code Section 351

There were several comments by BOE staff at the June 1st interested parties meeting to the effect that Regulation 1603 only makes reference to Labor Code Section 351 for the purpose of requiring restaurants to include gratuities in their gross receipts if they violate Section 351 and keep the employee’s gratuities. We respectfully disagree.

Not only does Regulation 1603 specifically reference Labor Code Section 351, but the language in Regulation 1603 is patterned after the language in Section 351. With a few minor exceptions, the entire first sentence of Regulation 1603(g), entitled “Tips and Service Charges,” is identical to the first sentence in Labor Code Section 351.

Regulation 1603: “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: “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.”

This identical patterning between these provisions cannot be ignored. Regulation 1603’s adoption of the language in Labor Code Section 351 should make it clear that *any* gratuities given to the employee are the property of the employee and are not subject to tax. Whether the gratuity is mandatory or optional is irrelevant for purposes of this inquiry.

The provisions which have caused the most confusion and debate regarding the taxability of gratuities are the Caterer provisions under subsection (h) of Regulation 1603. Separate and apart from the “tips and service charges” provisions in subsection (g), there is another set of

“tips, gratuities and service charges” provisions under subsection (h)(3)(E) arguably pertaining (only) to “Caterers.” The provisions in subsection (h)(3)(E) were added as amendments to Regulation 1603 in 2002 and have caused much debate since that time. The subsection (h)(3)(E) provisions create the “mandatory” versus “optional” distinction. According to several BOE staff members at the June 1st interested parties meeting, the subsection (h)(3)(E) provisions apply to all food service operators and not just caterers, despite the subsection’s placement in the “Caterers” portion of the regulation. BOE staff suggested at the June 1st interested parties meeting that the mandatory versus optional provisions in subsection (h)(3)(E) could be moved to subsection (g) to provide better clarity regarding their application.

Irrespective of the placement within Regulation 1603, the mandatory versus optional distinction finds no basis in Section 6012, Labor Code Section 351 or California case law for the reasons articulated above.

* * *