



Tips and Gratuities Fact Sheet

Tip Laws in California

Tips are common in many service and hospitality-based industries, including at restaurants, valets, hotels, beauty salons, spas, etc. California views tips, known as “gratuities,” as the sole property of an employee who the tip was paid to, given, or left for. California Labor Code section 351 specifically *prohibits* employers from:

- Sharing in any tips or gratuities;
- Counting tips towards minimum wage requirements and/or offsetting wages based on tips received (known as “tip credits”);
- Deducting employer expenses from tips.

Note that federal law is less restrictive than California. For example, under federal law, employers may make deductions for credit card processing fees. Federal law also allows employers to claim certain tip credits to offset minimum wage obligations.

Tips v. Service Charges

It is important to distinguish between tips and service charges, as service charges are treated differently under California law. Tips are defined as “any tip, gratuity, [or] money,” that has been paid, given, or left by a patron to an employee over and above the amount due for services or goods. An important distinguisher is that tips are *optional*.

On the other hand, service charges are additional fees added to a customer’s bill that they are obligated to pay. Service charges are typically calculated as a percentage of the total bill, for service-related costs. Employers may generally keep all service charges, or choose to share them with employees. However, employers should be aware that there are a number of *local ordinances* requiring covered employers in hospitality industries to pay all required service charges directly to their hospitality workers.

If an employer implements a “mandatory gratuity” it is best to consult legal counsel regarding how it should be classified, for both HR compliance and tax purposes. The determination may depend on specific facts showing how the charge is perceived and intended by a customer. Courts have

examined factors such as what customers thought the “service charge” was meant for, how the contracts between the parties described the charge, and industry custom and practice.

Tips Paid by Credit Card

As noted above, employers cannot make deductions for business expenses from an employee’s tips, and this includes deductions for credit card processing fees. This means that even if a customer leaves a tip for an employee on their credit card and this results in a service processing fee to the employer, the employer is not allowed to pass that cost on to the employee. Additionally, tips paid using credit cards must be paid to the employee by the next regular payday following the date the patron authorized the credit card payment.

Tax Implications

Both cash and non-cash tips are subject to federal income taxes. The IRS defines “tips” as:

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

Employers should develop a system for employees to keep track of their tips daily. Additionally, the IRS requires employees to report all cash tips to their employer in a written statement on a monthly basis. The only exception is when total tips received by the employee during a single calendar month by a single employer are less than \$20. In that case, tips are not required to be reported and taxes are not required to be withheld.

In all other instances, employees should document and report the following information to the employer by the 10th of the month after the month the tips are received:

- Employee signature,
- Employee’s name, address, and Social Security number,
- Employer’s name and address (establishment name if different),
- Month or period the report covers, and
- Total of tips received during the month or period.

Employers are required to retain employee tip reports. Employers are also required to withhold taxes (including income taxes and the employee’s share of Social Security tax and Medicare tax) based upon wages and tip income received by the employee and to deposit this tax.

In addition, employers are required to pay the employer share of Social Security and Medicare taxes based on the total wages paid to tipped employees as well as the reported tip income. This information and tax are finally reported to the IRS on the appropriate forms by the employer.

To learn more about tax obligations, refer to the [IRS website here](#), or consult with a tax advisor.

Regular Rate of Pay

Employers may wonder whether tips impact a non-exempt employee's "regular rate of pay," for purposes of calculating overtime, premium pay obligations, paid sick leave, and reporting time pay. Because tips are left voluntarily by a customer and not paid by the employer, they are not factored into the regular rate of pay.

However, be careful if you have a practice of distributing all or part of any mandatory service charges to your employees. In that case, the service charge paid to employees will likely impact the regular rate of pay.

Tip Pooling Programs

Involuntary tip pooling programs are lawful in California, so long as the tip pooling policy is not used to compensate any "agents" of the business, such as owners, managers, or supervisors. This restriction applies even if these individuals provide direct table service or are in the chain of service to the patron. While in *Chau v. Starbucks Corp.*, the court made an exception and found it was lawful for a shift supervisor to participate in a tip pool where there was a collective tip box for all service employees, the court's analysis was *fact specific*. As a general rule, it is not a recommended practice to allow supervisory employees to participate.

Additionally, an employer's tip pooling policy must be considered fair and reasonable. The policy should only distribute tips to staff involved in "direct table service" or who are in the "chain of service," impacting the customer's overall experience. In addition to hosts and waiters for example, courts have found kitchen staff, bartenders, and dishwashers may also participate. However, there still must be a reasonable relationship between the service and tip distribution. For example, a policy in which 80 percent of tips were allocated to waiters, 15 percent to busboys and five percent to bartenders has been found reasonable in one case.

In drafting a tip pooling policy, it is important for employers to define what tips qualify to be "pooled," who is eligible to participate in tip pooling and when, and timing and distribution of tips. However, because there are no bright-line rules regarding what is reasonable, it is often best to consult legal counsel on any tip pooling arrangements.

For more information, employers can refer to the DIR's frequently asked questions on tips and gratuities [here](#).