

Treatment of Service Charge for Revenue and
Expense Reporting
In the Hospitality Industry

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The Issue¹

It is usual and customary in the hospitality industry to apply a fixed percentage mandatory service charge to certain revenues. In many cases, some or all of the service charge is paid to hotel employees to supplement their base wages.

In drafting of the 11th edition of the *Uniform System of Accounts for the Lodging Industry*, the American Hotel & Lodging Association Financial Management Committee (the “Committee”) had to determine whether (i) the full amount of the service charge billed to customers should be treated as revenue and the portion (if any) paid to employees deducted as a wage expense, or (ii) the amount of the service charge to be treated as revenue should be net of amounts paid (if any) to employees (with such employee payments treated as a pass through on the balance sheet).

In considering this question, it is important to differentiate a tip or gratuity from a service charge. A gratuity is a payment made at the discretion of the customer and the customer solely determines the amount of the payment. A service charge is a mandatory amount billed to the customer’s account and the customer has no discretion as to payment, the amount of the charge, or its distribution to employees.

Consideration of Applicable Rules, Standards and Legislation

There are two interrelated revenue and expense principles to be considered:

- (a) whether a service charge should be fully included in revenue or only the net amount retained by a hotel after payment of any portion to employees, and
- (b) whether the portion paid to employees of a mandatory fixed amount payable by customers should be considered a wage expense or a pass through on the balance sheet.

Inclusion in Revenue: Gross versus Net

To determine the appropriate reporting treatment of service charges as revenue in the U.S., reference is made to EITF-99-19, which was later translated to FASB codification 605-4545. FASB codification 605-4545 addresses revenue recognition in the context of principal and agent relationships.

Determining factors of gross revenue reporting are found in the eight indicators to support reporting gross revenue in 605-4545 which, together with their applicability to service charge revenues, may be summarized as follows:

Note: This brief reflects the views and opinions of Christopher Garland as a member of the Financial Management Committee of the American Hotel & Lodging Association (“AH&LA”). This brief may not be (i) used by the AH&LA for any purpose other than the publication in the AH&LA’s April 2015 newsletter, or (ii) by any other person or group (including the Committee) for any purpose whatsoever. In addition, this paper does not provide, and shall not be deemed to provide, legal or tax advice of any nature. Reference should be made to appropriate advisors.

1. The Entity is the Primary Obligor in the Arrangement – Yes - The hotel (not its employees) is responsible for fulfillment of the customer arrangements, including the acceptability of the products or services.
2. The Entity has General Inventory Risk Before the Customer Order is Placed – Not applicable as service charge is an intangible.
3. The Entity has Latitude in Establishing Price – Yes – The hotel determines the level of service charge to be applied to customer invoices.
4. The Entity Changes the Product or Performs Part of the Service – Yes – The hotel is responsible for providing the location, materials, training and standards to ensure the value of the service provided to customers.
5. The Entity Has Discretion in Supplier Selection – Yes – The hotel has discretion over the hiring of its employees and determines which employees will provide the service ordered by the customer.
6. The Entity is Involved in the Determination of Product or Service Specifications – Yes – The hotel determines the service standards.
7. The Entity has Physical Loss Inventory Risk After the Customer Order – Not applicable as service charge is an intangible.
8. The Entity has Credit Risk – Yes – The hotel (as employer) generally must pay the service charge to its employees regardless of whether the customer pays the hotel.

Service charges meet six of the eight criteria for gross reporting, with two factors not being applicable since service charges are an intangible. Therefore there is a preponderance of characteristics which indicate the revenue should be reported on a gross basis.

In comparison, the three indicators of Net Revenue Reporting do not support Net Revenue Reporting of Service Charge as indicated by the following review of 605-45-45-15:

1. The Entity's Supplier is the Primary Obligor in the Arrangement – No – Clearly the hotel (not its employees) is the party obligated to customers to provide services.
2. The Amount the Entity Earns is Fixed – Yes – The hotel owner earns a stated percentage. In the hotel context, this does not appear to be applicable since the “supplier” (ie. the employees) are not likely to be in an agency relationship with their employer.

3. The Supplier Has Credit Risk – No – The hotel has the credit risk. As stated above, the hotel (as employer) generally must pay the service charge to the employees regardless of whether the customer pays the hotel. In other words, the employees (even if they were to be considered suppliers) have no credit risk.

605-45-45-1 states that it is a matter of judgment whether an entity should report revenue based on either of the following:

- a. The gross amount billed to a customer because it has earned revenue (as a principal) from the sale of the goods or services
- b. The net amount retained (that is, the amount billed to the customer less the amount paid to a supplier) because it has earned a commission or fee as an agent.

When this statement is applied to service charge revenues billed to a customer, it indicates that the gross amount of the service charge should be included in revenue where the service charge is earned by a hotel as a principal. Only if such service charge is paid to a hotel as an agent for a supplier should solely the net amount retained by the hotel be considered revenue. It is likely that there are very few circumstances (if any) in which the employer would be agent for the employees and the provision of services by employees of the hotel would certainly not qualify.

As indicated by the above analysis, application of FASB Codification 605-4545 clearly identifies that service charges should be reported on a gross revenue basis.

The U.S. Department of Labor Wage and Hour Division discusses Service Charges in Fact Sheet #15 revised in March 2011. Under the heading “Service Charges”, the fact sheet states “A compulsory charge for service, for example, 15 percent of the bill, is not a tip. Such charges are part of the employer’s gross receipts.”

Inclusion as Expense - Characterization

The Internal Revenue Service outlines the factors for determining the characterization of a payment in Rev. Rul. 59-252. A “tip” must meet all four of the following factors:

- The payment must be made free from compulsion;
- The customer must have the unrestricted right to determine the amount;
- The payment should not be the subject of negotiation or dictated by employer policy; and
- Generally, the customer has the right to determine who receives the payment.

A mandatory amount or percentage applied to a customer account does not meet any of the four criteria set out in Rev. Rul. 59-252 and is therefore a service charge.

In June 2012, the IRS issued bulletin 2012-26 in respect of Rev. Rul. 2012-18, which affirms the criteria set out in Rev. Rul. 59-252 and gives further guidance that distributed services charges are properly characterized as wages and not tips. This guidance also

provides that service charges are not eligible for the tip credit claimed on Form 8846. The effective date of Rev. Rul. 2012-18 is immediate, however because the IRS is aware that some businesses may have to change automated or manual reporting systems in order to comply with the proper treatment of service charges, the interim guidance provides that in specified limited circumstances examiners would apply the rule prospectively to amounts paid on or after January 1, 2013.

The Internal Revenue Service supports the Department of Labor opinion with respect to their form 4070A and Publication 1244 pertaining to employees daily tip records. In reference to service charges, this document requires that they be excluded from tip reporting and further states “This is part of your wages, not a tip”.

Despite the foregoing, the New York Court of Appeals ruled in *Samiento v. World Yacht, Inc.*, 10 N.Y. 3d 70 (Feb. 14, 2008) that pursuant to New York Labor Law section 196-d, service charges may now be considered gratuities and cannot be retained by the employer. However, this treatment of service charges does not apply if certain requirements are met. Notification to the customer that a service charge may not be paid fully to the employees constitutes the primary requirement to be met. The court focused on whether a reasonable customer believes that the service charge is a gratuity and if so, the entire charge must be distributed to the service team. The decision of the court was based on consumer fraud and employee welfare concerns, not GAAP or IRS rules.

Additionally, employers who claim the Section 7(i) overtime exemption under the Fair Labor Standards Act should be aware that “tips” paid to service employees by customers may never be considered commission for the purposes of this exemption, per Wage and Hour Division Fact Sheet #20, revised July 2008.

Summation

The Internal Revenue Service (Rev. Rul. 59-252) and the U.S. Department of Labor Wage & Hour Division (Fact Sheet 15) both clearly identify a mandatory service charge on a customer’s account as being a “Service Charge”. The clear distinguishing factors which constitute a “tip” are the ability of the customer to (a) make the payment free from compulsion, (b) have the unrestricted right to determine the amount of the payment, (c) not have to negotiate the payment, and (d) determine who receives the payment. None of these factors are applicable to service charges. The U.S. Department of Labor Wage and Hour Division Fact sheet #15 further states that service charges must be reported as gross receipts. A mandatory charge on the customer account does not constitute a tip.

The labor law of New York does not dispute the fact that a properly disclosed mandatory charge is a service charge, however in the interest of consumer protection and employee welfare, they have deemed that failure to disclose the nature of the charge may change the nature of the payment to a gratuity, despite the mandatory application. Where properly disclosed, even the state of New York views mandatory charges as service charges, not gratuities.

It should not be forgotten that the Uniform System of Accounts for the Lodging Industry is intended to represent standards and principles of accounting for the whole of the United States and should not be overly influenced by one or two states that deviate from the majority, for purposes not associated with accounting treatment.

Having established that service charge is revenue, the question to determine is whether it should be included in revenue in its gross amount or only on a net basis. Applying the criteria prescribed by FASB Codification 605-4545, mandatory service charges meet a preponderance of criteria for reporting this revenue on a gross basis and fails to meet the criteria for reporting on a net basis. Service charges should therefore be reported as revenue at the gross amount.

When included in revenue at the gross amount, the payment of service charges to employees must be reported as an expense to ensure the correct calculation of net profit. This is supported by IRS bulletin 2012-26 in respect of Rev. Rul. 2012-18 in which distributed service charges are properly characterized as wages, as confirmed by the Department of Labor Wage and Hour Division Fact Sheet #15.

It is practical to record the mandatory service charges both as gross receipts and wage expense to ensure proper record keeping for the purpose of facilitating the filing of Form 1120, U.S. Corporation Income Tax Return. The service charges must be reported as gross receipts on line 1b, and must be reported as salary and wage expense on line 13.

Conclusion

U.S. Generally Accepted Accounting Principles and the requirements of both the Internal Revenue Service and the Department of Labor provide overwhelming direction that mandatory service charges billed to a customer account should be reported as revenue at the gross amount and the corresponding expense must be treated as a wage cost. The nature of the payment is not changed based on whether the service charge is paid to employees in full, in part or not at all. Instead, reporting requirements for a fixed percentage mandatory service charge are clearly defined and their treatment as revenue and expense is unquestionably prescribed by the federal government.

The 11th edition of the Uniform System of Accounts for the Lodging Industry continues to correctly reflect the treatment of Service Charge as revenue as was determined to be appropriate by the committees that drafted the 9th and 10th editions of this publication.

About the Author

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