Cite as Det. No. 06-0030, 26 WTD 50 (2007)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of . . .	)	D E T E R M I N A T I O N No. 06-0030 Registration No. . . . FY . . ./Audit No. . . . Docket No. . . .

[1] RULE 119; RCW 82.04.070: RETAIL SALES TAX – B&O TAX – GRATUITIES. If a caterer discusses gratuities before service is rendered, and the customer agrees that a gratuity of a certain amount will be added to the price, payment of the gratuity is not clearly voluntary, and the caterer must include the amount received in the measure of the tax. On the other hand, if a caterer discusses gratuities before service is rendered, and it is agreed that the customer will only pay an amount based upon the actual quality of service rendered, the gratuity is considered voluntary.

[2] RULE 119; RCW 82.04.070: RETAIL SALES TAX – B&O TAX – GRATUITIES. When a caterer includes on its invoices a separate line item of a stated amount labeled "suggested" or "recommended" gratuity, inclusion of the stated amount does not require a finding that the gratuity was mandatory. Nor does the label, by itself, establish that the gratuity was voluntary. The caterer must come forward with other evidence that the amount was not an agreed-upon addition to the contract price and the gratuity was optional.

[3] RULE 118: RETAIL SALES TAX – B&O TAX – RENTAL OF ROOM FOR EVENT – CATERERS. When a caterer rents space for an event incidental to catering the event, the contract should not be bifurcated, and the entire charge for the catering and space should be taxed under the retailing and retail sales tax classifications. When a caterer rents an event room not in conjunction with catering the event, the rental income should be reported under the service and other business activities classification.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Prusia, A.L.J. – A catering business appeals the assessment of Business and Occupation (B&O) tax on revenues from service charges it included as a separate line item in its billings, contending the revenues were voluntary gratuities that should not have been included in the selling price of the meals. It also appeals future reporting instructions that it should report revenue from separately-stated room rental under the retailing/retail sales tax classification rather than under the service and other activities B&O classification. We find the service charges were voluntary, conclude the revenue should not have been included in the selling price, and cancel the assessment of additional tax on those revenues. We conclude that the room rentals are taxable under the retailing and retail sales tax classifications when renting the room is incidental to the catering and part of the same service and contract, but are taxable under the service and other business activities classification when the rental is not in conjunction with catering the event.[1]

ISSUES

[1] Were unreported service charges or gratuities clearly voluntary? Should they have been included in the selling price of the catered meals?

[2] What is the appropriate B&O classification of revenues from charges for the rental of event or banquet rooms?

FINDINGS OF FACT

[Taxpayer] is a Washington corporation engaged in business in Washington in operating a catering business. It also has [rooms] at its facility that it rents to the public, usually in conjunction with its catering activity.

The Audit Division of the Department of Revenue examined the books and records of Taxpayer . for the period January 1, 2000 through December 31, 2003 ("audit period"). As a result of that examination, . . . the Audit Division issued an assessment against Taxpayer for additional taxes. . . . Taxpayer appeals the assessment, and it remains unpaid. The issues in dispute concern the assessment's inclusion of unreported revenue from service charges in the measure of the retailing B&O and retail sales tax due, and future reporting instructions regarding revenue from renting rooms.

Gratuities

During the audit period, Taxpayer received amounts that it designated as gratuities or tips. It was Taxpayer's understanding, based on discussions with other people in the industry and its accountant, that it could discuss gratuities and suggest an amount, but could not make the gratuity mandatory. Based on that understanding, Taxpayer's catering sales staff, when explaining the food selections and services Taxpayer offered, stated that because the events are food service events, it's traditional that a portion of the server's compensation comes from a

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

gratuity based on the customer's satisfaction, the suggested amount is . . .%, but payment and amount of the gratuity are up to the customer's discretion. Taxpayer's brochures stated that "A suggested . . .% service charge will be added to all menu prices." Breakdowns of projected charges were given customers, which included sales tax and a ". . .% suggested service charge. . . ." Projected menus stated a menu price [which gave menu price per guest plus sales tax and the suggested gratuity amount based on a certain number of guests].

In all cases except those described in the second paragraph below, when Taxpayer billed for an event, it provided a breakdown of the charges as well as an invoice. The breakdown included taxes and "Suggested Gratuity" in a specific amount and percentage . . . . The invoice included the line item ". . . Suggested service charge," in a specified dollar amount. Taxpayer did not include the suggested gratuity in the measure of the sales tax on either document. However, it did include the service charge in the only stated total, on both documents; neither stated a total price before gratuity. Usually customers paid the suggested gratuity, but some customers changed the amount after receiving the invoice, and Taxpayer always honored the customer's determination of the appropriate gratuity after the event.

Taxpayer has provided the Appeals Division with nine letters or email messages from past repeat customers, addressing the customers' understanding of the nature of the suggested gratuity. All state they understood that the suggested gratuity was voluntary, a discretionary amount, or just a suggested guideline. Several state that Taxpayer was always very clear about the discretionary nature of the gratuity in conversations and written materials. One customer states it has deviated from the suggested guideline at least 25% of the time. Taxpayer also provided invoices on which the customer changed the amount of the gratuity, and Taxpayer then issued a corrected invoice with the amount the customer had designated.

In a few cases, the customer needed a fixed price, for budgetary certainty. In those cases, Taxpayer negotiated a total price, including gratuity. When invoicing, Taxpayer charged retail sales tax on the total price, including gratuity, and remitted the collected tax to the Department.

Taxpayer paid 100% of suggested gratuity receipts to its serving staff. Taxpayer treated receipts from suggested gratuities as a payroll trust fund liability. At various times it had three different pre-programmed accounts . . . for suggested gratuities, labeled ". . . percent suggested gratuity," ". . . percent suggested service charge," and "gratuity as directed by client." When a gratuity was negotiated and set in advance, Taxpayer used a separate . . . account to record the revenue. Taxpayer handled the receipts in this manner because of IRS requirements for reporting employee tips.

During the audit period, Taxpayer did not charge customers retail sales tax . . . on amounts it recorded as gratuities, except when the service charge was negotiated and set in advance. Taxpayer did not include amounts recorded as voluntary gratuities in the gross revenues it reported to the Department.

In making the assessment, the Audit Division included all gratuities that Taxpayer had not reported as part of the selling price on which retailing B&O tax [and] retail sales tax . . . was due, and assessed the unpaid taxes. . . .

Room charges

Taxpayer rents the building space where it has its offices and food preparation facilities. Sometime before the audit period, Taxpayer rented additional space at its location so it could have a [room] to offer to clients who did not already have a location for the event they wanted catered. . . . Taxpayer made its [rooms] available to clients for an additional charge. Proposals, breakdowns of projected charges, and invoices included a line item for [room] rental. Taxpayer sometimes rented a room without catering the event.

For the years 2000 and 2001, Taxpayer reported income from event room rentals under the retailing B&O and retail sales tax classifications. In 2001, Taxpayer inquired of the Department's Taxpayer Services Division how to report the separate charges for facilities . . . rental. Taxpayer Services gave Taxpayer instructions which Taxpayer understood required it to report the revenues from the [room] rental line item under the Service and Other Activities B&O classification. For the years 2002 and 2003, Taxpayer reported those revenues under Service and Other Activities, and did not collect retail sales tax on those charges.

In making the assessment, the Audit Division concluded that the line items for [room] rental were not actually a separate [room] rental, but rather part of the catered event and as such a part of the selling price, and retailing B&O tax and retail sales tax should have been reported on the revenue. The Audit Division did not adjust the tax amount due on the revenues for the years 2002 and 2003, because of the instructions Taxpayer had received from Taxpayer Services, but issued future instructions consistent with its conclusion that the revenues should be reported under the retailing and retail sales tax classifications.

Taxpayer appeals the assessment of B&O tax [and] retail sales tax . . . on unreported income it considers gratuities. It appeals the future reporting instructions regarding charges for [room] rentals, asking the Department to clarify its position.

ANALYSIS

Washington imposes a B&O tax "for the act or privilege of engaging in business" in the State of Washington. RCW 82.04.220. The B&O tax measure and rate are determined by the type or nature of the business activity in which a person is engaged. Ch. 82.04 RCW. Washington levies a retail sales tax on each retail sale in this state. RCW 82.08.020 and 82.04.050.

[1] Gratuities/tips/service charges

Sales of meals and prepared food by caterers are subject to B&O tax under the retailing classification when sold to consumers, and the retail sales tax applies to most sales of meals upon which the retailing B&O tax applies. WAC 458-20-119 (Rule 119).

The measure of the retailing B&O tax is the gross proceeds of the sales. RCW 82.04.250(1); RCW 82.04.070. The measure of the retail sales tax is the selling price. RCW 82.08.020(2). The selling price includes the total consideration paid or delivered by a buyer to a seller. RCW 82.08.010(1).

Rule 119 explains that gratuities that are clearly voluntary are not part of the selling price:

> **Gratuities.** Tips or gratuities representing donations or gifts by customers under circumstances which are clearly voluntary are not part of the selling price subject to tax. However, mandatory additions to the price by the seller, whether labeled services charges, tips, gratuities, or otherwise must be included in the selling price and are subject to both the retailing classification of the B&O tax and the retail sales tax.

Rule 119 and published Department determinations provide examples and further clarification of when gratuities are taxed as part of the selling price, and when not. Rule 119 provides the following example:

> (c) Y Motor Inn contracts with Z Company to provide catering services for a function to be held at the motor inn. During discussions concerning the services to be provided, Z Company is informed that a 15% gratuity is generally recommended. Z Company negotiates the gratuity percentage to 10% and signs a catering contract stating that the agreed gratuity will be added. The gratuity charged to Z Company is subject to both the retailing B&O and retail sales taxes. This is not a voluntary gratuity since it is required to be paid as a condition of the contract. Gratuities are not part of the selling price only when they are strictly voluntary.

Det. No. 87-71, 2 WTD 361 (1987), addressed several contracts involving the catering of banquets and other group events by a hotel. The hotel's catering manager or other employee provided catering customers with a banquet brochure that stated the prices for food and a recommended 15% gratuity. In five of the contracts, the employee requested that the customer pay the industry standard 15% gratuity, the customer agreed to pay that amount or a lesser amount, and the contracts stated that Washington sales tax and the agreed gratuity would be added. In four of those five contracts, the customer was billed the amount of the agreed gratuity. In the fifth, the hotel did not explain why the agreed gratuity was not billed. Det. No. 87-71 held that because the amount of the gratuity in those five contracts was negotiated and the customer agreed that a gratuity of a certain amount would be added, the payment of the gratuity was not clearly voluntary, and was part of the selling price. In a sixth contract, the customer had sent the hotel a preliminary arrangement memo that stated it was understood that gratuities were not considered by the hotel as an automatic add-on charge for function costs, and the decision whether to provide a gratuity was solely a decision of the customer and would be based on the quality of service rendered. The contract also left the amount of the gratuity blank, stating the amount was "to be determined." Det. No. 87-71 held that in this example, if the customer paid a gratuity, the payment was voluntary. Det. No. 87-71 further stated:

> We do not find that simply because gratuities are discussed and agreed to, the Department considers them voluntary and not subject to tax. If gratuities are discussed and the customer agrees that a gratuity of a certain amount will be added, the payment of the gratuity is not clearly voluntary. On the other hand, if the gratuities are discussed and it is agreed that the customer will only pay an amount based upon the actual quality of the service rendered . . . the gratuity is considered voluntary.
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> Common synonyms for voluntary include spontaneous, discretionary, unsolicited, optional, of one's own choice, freely given, etc. Roget's International Thesaurus, at 479 (4th Ed. 1977). Charges do not meet the common understanding of the word "voluntary" when they are agreed upon and the contract document states that they "will be added."

Det. No. 95-038E, 15 WTD 123 (1996), addressed the situation where a caterer discussed the amount of the gratuity with the customer at their first meeting, the caterer and customer agreed upon an amount, and, after the catering event, the caterer separately itemized the agreed gratuity amount on the invoice to the customer. Det. No. 95-038E held that the gratuities were not clearly voluntary, and were taxable in full as part of the consideration for the service. Det. No. 95-038E stated:

> Only in situations where the customer alone determines the amount of the gratuity after the taxpayer provides the service will it be considered voluntary. Amounts negotiated prior to providing the service will be considered consideration for that service.

(Emphasis original.) In Taxpayer's case, when Taxpayer negotiated a total price, including gratuity, before providing the service, Taxpayer properly included the service charge revenue in the selling price subject to retailing B&O tax and retail sales tax. Taxpayer does not argue with that, and we do not understand those reported revenues to be at issue in this appeal.

At issue are the unreported revenues from service charges, which we now address. The Audit Division concluded that it was not clear these gratuities were voluntary. Its analysis is as follows. The fact that the gratuity appears on the sales invoice, as a separate line item of a stated amount and percentage, is a significant factor. Even if the amount were not stated on the invoice, it is hard to imagine a customer would choose to leave nothing, because it's well-known and common in this industry to include gratuities, and customers expect to pay a tip. Another significant factor is that Taxpayer books the amounts in its accounting records . . . . Tips that are added by the customer generally will not be booked nor will the percentage be prescribed. It is extremely unlikely that amounts left on the tables by the customers would be booked in the accounting records. The Audit Division also argues that no evidence exists that proves that the customer alone determines the actual percentage or at what time the percentage amount is determined.

We analyze the matter somewhat differently. The above determinations provide an objective test for resolving the gratuity issue. If gratuities are discussed before service is rendered, and the customer agrees that a gratuity of a certain amount will be added, the payment of the gratuity is not clearly voluntary. If the gratuities are discussed before service is rendered, and it is agreed

that the customer will only pay an amount based upon the actual quality of the service rendered, the gratuity is considered voluntary. The difficulty arises in establishing what the parties agreed to before service was rendered. The burden is on the taxpayer, if it alleges that it is agreed the customer will only pay an amount based upon the quality of the actual service rendered, to prove that is its practice.

[2] We do not agree with the Audit Division's analysis that including the gratuity on the sales invoice, as a separate line item of a stated amount and percentage, necessarily requires a finding that the gratuity was not voluntary. To limit Rule 119's exclusion for gratuities to ones that are not discussed at all beforehand and are spontaneous on the customer's part would go significantly beyond the position stated in Det. Nos. 87-71 and 95-038E. A social compulsion to observe a tipping schedule does not make tipping mandatory. Nor do we agree with Taxpayer that labeling the line item "suggested" or "recommended," by itself, establishes that there was an agreement that the customer would only pay an amount based upon the quality of the actual service rendered. It could be a label for the amount that was recommended **and** agreed upon beforehand. When the gratuity amount on the invoice is not a blank that the customer must fill in after the event, or the invoice does not clearly draw the customer's attention to the optional nature of the gratuity, such as by stating the line item after the total price before gratuity and expressly stating the tipping policy, a taxpayer must come forward with other evidence that, when it includes on its invoices a specific line item for a "suggested" or "recommended" gratuity of a stated amount, the amount was not agreed upon beforehand. Evidence that, on an ongoing basis, not all customers pay the amount that is labeled as suggested or recommended, particularly evidence showing they cross out or otherwise alter the amount, would tend to indicate that gratuities that are labeled as suggested or recommended truly are voluntary. Statements from customers regarding their understanding of the voluntary nature of the amount would also be relevant evidence. Any evidence that the business does not always honor the customer's determination of the appropriate gratuity after the event would be inconsistent with a claim that the gratuities labeled as suggested or recommended were truly voluntary.

In the present case, Taxpayer's written proposals, contracts, and invoices always labeled the gratuity as a "suggested" service charge, which is consistent with its claim that the gratuity was voluntary. On the other hand, the service charge was a stated amount on the invoice, was included in the only total price that was stated on the invoice, and there is nothing on the invoices that clearly calls the customer's attention to the optional nature of the charge; these facts raise some doubt whether the invoices were stating an amount already agreed upon. Taxpayer has come forward with additional evidence, which tips our decision in its favor. Nine customers have provided statements supporting Taxpayer's assertions, and Taxpayer has provided invoices showing some customers did change the amount of the gratuity after service was provided, and Taxpayer accepted the change. The fact that Taxpayer charged sales tax when customers contracted beforehand to pay a definite amount is another circumstance that bolsters Taxpayer's assertion that service charges labeled as "suggested" were not agreed upon in advance, and were truly voluntary.

The fact that Taxpayer books the amounts in its accounting records is not determinative. IRS regulations require employers to report employees' tips and withhold taxes. *See* 26 CFR

§31.6053-3; IRS Form 8027. It is the treatment and distribution of the booked gratuities that is important. In this case, the evidence is that the booked gratuities were not treated as revenue of the business, are not retained by the business, and were distributed to the employees as gratuities and not as wages.

Based upon the facts presented and the above analysis, we conclude that the disputed gratuities in this case were not mandatory, and neither the payment of a gratuity nor the amount was agreed to in advance. During the audit period, gratuities labeled as suggested on invoices were clearly voluntary and not part of the selling price.

[3] Room rental -- future reporting instructions

Under Taxpayer's facts, a number of principles come into play in determining the appropriate taxation of its room rental revenue.

The B&O tax measure and rate are determined by the type or nature of the business activity in which a person is engaged, and a given business may involve more than one classifiable activity. *See, e.g.*, RCW 82.04.440; WAC 458-20-224 (Rule 224); WAC 458-20-148 (Rule 148); *Group Health Cooperative of Puget Sound v. Department of Rev.*, 106 Wn.2d 391, 722 P.2d 787 (1986). Even when a taxpayer performs separate activities which are a minor concomitant of the taxpayer's primary business and result in income, it is appropriate to tax the separate business activities according to the nature of the activity. *See, e.g.*, WAC 458-20-13501 (11) (timber harvest operations performed as an incident to construction of roads or land clearing). On the other hand, the Department does not generally allow a single contract to be segregated unless there is a reasonable basis on which to do so. As we stated in Det. No. 91-163, 11 WTD 203 (1991):

> We must determine the predominant nature of the contract to determine the business and occupation tax classification of the receipts received under its terms. We must also determine if it is a separate service, severable from the contract.

As we also stated in Det. No. 89-433A, 11 WTD 313 (1992):

> We do believe that bifurcation of a contract for taxation will be the unusual case. In most cases income from a performance contract will be taxed according to the primary nature of the activity. For example, income from processing for hire is taxed at the processing for hire rate even though some storage or other services are also involved.

The activities of a catering business are primarily the sale of meals and prepared food, and are subject to B&O tax under the retailing classification when sold to consumers. Rule 119. WAC 458-20-118 (Rule 118), referenced in the 2001 Taxpayer Services letter to Taxpayer, addresses the taxation of persons who are in the business of selling or renting real estate. Rule 118 states that amounts derived from the granting of a license to use real property are taxable under the service and other business activities B&O classification, unless otherwise taxed under another classification by specific statute. No specific statute prescribes the taxation of all services of a

catering business.[2] Therefore, its revenue from the rental of rooms is potentially subject to the service and other business activities B&O classification.

In Taxpayer's case, the rental of the event room usually is incidental to the catering of the event, and is part of the same service and contract. In those cases, the contract should not be bifurcated, and the entire amount should be taxed under the retailing classification and retail sales tax collected. When Taxpayer rents an event room not in conjunction with catering the event, the revenue should be reported under the service and other business activities classification.

DECISION AND DISPOSITION

We grant the petition on the unreported gratuities issue, and modify the future reporting instructions with respect to revenue from the rental of event or banquet rooms. We remand the matter to the Audit Division for adjustment of the assessment in accordance with this decision.

Dated this 24th day of February 2006.

[2] In contrast, a specific statute defines **all services** of a hotel, motel, or similar business as being a retail sale, and therefore the rental of meeting rooms or ballrooms by such businesses are retail sales.