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## **Use of Surcharges and Best Tips to Avoid False Advertising and Other Consumer Claims**

Due to a myriad of legislative and court decisions, some hotels and restaurants particularly in California have elected to add a surcharge to their receipts to defray increased costs incurred over the last several years.

The increased costs of operating can be attributed to minimum wage increases, healthcare, paid sick leave, restrictive scheduling, cost of food and supplies and increase pay equity between traditionally tipped employees and heart of the house employees. As such, these surcharges need to be analyzed for taxation purposes and legality as to how they are implemented.

### **A. Tax and Wage Implications**

First let us think about how surcharges affect a company from a tax and reporting perspective. Starting in 1994, hospitality companies have benefited from being allowed to apply a general business credit toward a portion of the employer's Social Security and Medicare taxes paid with respect to their employees' cash tip earnings (IRC 45 B). However, the policy set forth in Rev. Rule 2012-18 means that the credit would not apply with respect to surcharges, because these mandatory charges do not qualify as tips.

Surcharges like a service charge are a taxable event. The sales tax is imposed upon the retailer for the privilege of selling tangible personal property. "Gross receipts" provides that the taxable gross receipts include all amounts received with respect to the sale, with no deduction for the cost of the property sold, materials used, labor or service cost, or any other expense of the retailer passed on to the customer. Any expense of a restaurant passed on to customers in the form of a surcharge must be included in taxable gross receipts. Since there are no specific sales and use tax exemptions for a surcharge imposed, retailers may not claim the cost of the surcharge as a deduction on their Sales and Use Tax return. Therefore, a separate surcharge on customer bills must include the surcharge amount in the calculation of tax.

To the extent, a company elects to distribute a surcharge to its employees, the surcharge will be treated and must be reported as Salaries and Wages on the business tax return. Another issue to

consider is that an employer who pays out a portion of the surcharges to employees may have to recalculate its employees' overtime rates (if the employees work more than 40 hours in a week or 8 hours a day for businesses in California). As any distributed surcharges are wages, that money would count toward an employee's regular rate of pay and therefore must be factored into the overtime rate calculation.

### **B. Claims Asserted**

Starting in 2017 comments by several City Attorneys, as well as some letters, have raised issues concerning surcharges. Specifically, some City Attorneys have raised the manner under which surcharges are communicated to customers. Also in 2017, there were 16 cases filed in San Diego, California asserting the illegality of the surcharges and the manner of disclosure generally. These lawsuits claimed these restaurants were in violation of consumer protection laws including false advertising, unfair competition and misrepresenting the prices on their menus. It was further claimed that a failure to clearly and conspicuously communicate a surcharge might render the stated price of a food item untrue and misleading under California law. The San Diego City Attorney has made some statements that such charges are being investigated and may result in prosecution under the guise of consumer protection for false advertising. These lawsuits sought restitution, injunctive relief, civil penalties, punitive damages and attorneys' fees.

In a ruling on November 16, 2018, a San Diego Superior Court Judge ruled in granting judgment for the restaurant at issue that the "undisputed evidence establishes that the surcharge is not unlawful as a matter of law." Further, the Court concluded the restaurant "made adequate and non-misleading disclosures about the surcharge." Subsequent judgments were entered in favor of other restaurants by the same judge in December 2018 and January 2019 based on the November 2018 ruling; whereby the ruling of the Court was adopted as to the legality of the use of surcharges by restaurants. In February 2019, a federal judge also granted summary judgment concerning identical allegations concerning the use of a surcharge.

### **C. Prevention Tips**

As a result, even though surcharges are a legal and allowable option to help defray the recent increases in costs, there are some approaches that should be considered to avoid potential litigation. There are no regulations or laws that state how a restaurant should specifically and

clearly disclose the existence of a surcharge. However, to try and prevent the filing of an adverse claim, it would be prudent that a company discloses up front that the items for example a meal (food and drink item(s)) is subject to a surcharge and state the percentage of the surcharge on the menu, in a prominent sign or posting, on web pages, as well as on advertising materials either electronic or paper. Also even though not specifically required, it would be prudent that the disclosure stand alone and not be contained in a statement about other aspects of the business. Some companies have elected to highlight the disclosure in a different or larger font or color as a means to try and alleviate concerns raised by governmental entities. That said, there is no mandatory way that a surcharge should be disclosed to a customer. In summary, there is no legislative or statutory guidance as to how a surcharge should be disclosed.

There is no requirement that a sign be used to disclose a surcharge but having a surcharge disclosure sign is another means of avoiding a consumer claim. If a restaurant elects to use signage, there is also no requirement about the size of font on any sign posted in a restaurant about a surcharge. Hospitality companies who elect to use a sign should consider a sign about a surcharge and percentage where patrons are likely to see it as they enter the restaurant. A sign no smaller than 10 inches wide by 10 inches high or a horizontal strip marker no smaller than 10 ½ inches wide by 1 ¼ inches high bearing the surcharge information in at least a 36-point font would arguably comply with the “conspicuous” requirements. Also, if a fair amount of the business is take-out or occurs at a register, the placing of a disclosure sign at the register would likewise be another preventive step for notice purposes.

As to menus, any statement as to surcharges should be separate from other information. Some restaurants have elected to use bold font, a different color or italics. However, none of this is required. It is merely one option. In addition, the font as to the disclosure should not be smaller than other items printed on menus or electronic media and certainly at least the size of the menu items and the prices. These steps should help defray any claims that the restaurant did not clearly and conspicuously disclose the existence of a surcharge.

Many San Francisco restaurants implemented a surcharge (i.e., an extra fee or cost) on the goods or services they sell to customers to cover, in whole or in part, the expense of complying with the Health Care Security Ordinance passed in 2008. This surcharge was specifically designated to defray the costs of the local healthcare ordinance. Some restaurants faced litigation and penalties

when these surcharges were not utilized to pay for the cost of health care. There is now a requirement in San Francisco that the business on an annual basis disclose: 1) the amount collected from the surcharge for covered employee health care and 2) the amount spent on covered employee health care. Therefore, based on these lessons learned, if a company elects to impose a surcharge, it should consider disclosing it in a broad manner rather than designating it for a particular cost item. A more specific designation could subject the retailer to show that the surcharge collected must be only used for that item e.g., the cost of health care to employees. As a result, a broad designation of the surcharge would be a good preventive measure. The broader the language, the more flexibility the company has in how to utilize the money collected from the surcharge.

#### **D. Summary Recommendations**

Overall, surcharges are legal as supported by the recent court ruling. However, hospitality should implement surcharges with an eye toward prevention of any claims for consumer fraud, false advertising, unfair business practices or improper utilization of the surcharge. A company has wide discretion as to how it discloses and communicates the use of a surcharge but the disclosure should be sufficiently conspicuous to a reasonable consumer.

If a company elects to implement a surcharge, at a minimum the fact that there is a surcharge must be disclosed on the receipt as “SURCHARGE” and sales tax must be charged on all service charges and any separate surcharge line item, regardless of any amount that might be paid to the employees.

Herein is a summary of steps that a company should consider implementing, even though not currently required or mandated, as a means to prevent a legal claim:

- If a sign is utilized, take steps to place the sign at an entrance and/or at a check out area, disclosing the surcharge
- The use of the words “mandate” or “mandatory” when describing the surcharge, while not illegal, has been misinterpreted and has been criticized by some customers and political officials.
- Disclose the surcharge on menus, on websites and in advertisements, both paper and electronic, when the prices are disclosed

- Make sure the disclosure on the menu is at least the same font and size as the menu items and prices
- Keep any rationale as to the reason for the surcharge as broad as possible, e.g., to defray the increased cost of operations

Also, it is important to consult with your tax advisor or tax attorney to determine the proper method of taxing surcharges and paying your employees if a portion of the surcharge is distributed to the employees. It is also highly recommended to consult with qualified legal counsel concerning any questions about surcharges and how to disclose them to customers.



This report was reviewed for legal accuracy and updated in 2019 by Wilson Elser Moskowitz Edelman & Dicker LLP.