Recent Developments in the Treatment of Tips under the FLSA

by

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Background

Generally, the FLSA requires employers to pay a minimum wage of $7.25 per hour. 29 U.S.C. § 206(A)(i)(c). The FLSA permits employers to pay a so-called "direct wage" of $2.13 per hour to employees who are considered "tipped employees" (29 U.S.C. § 203(m)), so long as employees earns sufficient tips to meet the $7.25 per hour minimum wage requirement. Where tips do not make up the difference, the employer must supplement so the employee receives no less than the full minimum wage for all hours worked.

This paper addresses the following key topics relating to tips and the FLSA:

1. Tip credits
2. What constitutes a tip?
3. Which employees are "tipped employees"?
4. Dual employment
5. Employer deductions from tip credits
6. Notice requirements for use of tip credits
7. Tip pooling
8. Importance of State Law
9. Taxes

1. Tip Credits

Section 3(m) of the FLSA and the corresponding regulations allow employers to use a tip credit—paying employees below minimum wage and crediting the tips the employees receive to make up the difference between the hourly wage paid by the employer and the minimum wage. 29 U.S.C § 203(m); 29 C.F.R. §531.59. Thus, a "tip credit" is the amount of an employee's tips that the employer can use to make up the difference between $2.13 per hour and the $7.25 minimum wage. 29 U.S.C. § 203(m). If an employee's tips and the wage paid by the employer are less than the prevailing minimum wage, employers are required to make up any difference

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between the combination of the employee's hourly rate and tips and the prevailing minimum wage. *Davis v. B&S, Inc.*, 38 F. Supp. 2d 707, 712 (N.D. Ind. 1998) (holding that it is an employer's obligation to ensure that the tipped employee receives at least the minimum wage when the direct wage and his received tips are combined); 29 U.S.C. §203(m).

- If an employer elects to use the tip credit provision, the employer must: (1) inform each tipped employee about the tip credit allowance (including amount to be credited) before the credit is utilized and (2) be able to show that the employee receives at least the minimum wage when direct wages and the tip credit allowance are combined. *Winans v. W.A.S., Inc.*, 772 P.2d 1001 (Wash. 1989).

2. <u>What Constitutes a Tip?</u>

A tip is presented by a customer as a gift or gratuity in recognition of service performed. *Bingham v. Airport Limousine Serv.*, 314 F. Supp. 565, 572 (W.D. Ark. 1970); WH Admin. Op. (Dec. 26, 1973); WH Admin. Op. (Apr. 30, 1975); 29 C.F.R. §§ 531.52, .53. Tips must be money or its equivalent. 29 C.F.R. § 531.53. Any compulsory charges or service charges (such as banquet fees) are not tips even if distributed to employees. *Mechmet v. Four Seasons Hotels*, 639 F. Supp. 330 (N.D. Ill. 1986), *aff'd*, 825 F.2d 1173 (7th Cir. 1987); WH Admin. Op. (Jan. 15, 1975); WH Admin. Op. (Feb. 18, 1975); 29 C.F.R. §§ 531.52, .55. Compulsory and service charges can count towards minimum wage requirements. 29 C.F.R. § 531.55(b); *Melton v. Round Table Rest.*, 20 WH Cases 532, 535 (N.D. Ga. 1971).

3. <u>Which Employees are "Tipped Employees"?</u>

A "tipped employee" is "any employee engaged in an occupation in which he customarily and regularly receives more than $30 a month in tips." 29 U.S.C. § 203(t). For examples of types of employees who have been considered to "customarily and regularly" receive tips, s*ee* S. Rep. No. 93-690, at 43 (1974); U.S. Department of Labor Wage And Hour Division, Field Operations Handbook, § 30d04(a) (1988); Department of Labor Fact Sheet # 15, *available at* http://www.dol.gov/whd/regs/compliance/whdfs15.pdf (last visited June 10, 2010).

Tipped employees are subject to the protections of FLSA § 3(m). 29 C.F.R. § 531.57. An employee cannot be assumed to earn more than $30/month in tips because the employee is part of a group of employees who on average make that much in tips. 29 C.F.R. §531.56(c). The regulations define "customarily and regularly" as greater than occasional but less than constant. 29 C.F.R. § 531.57. Thus, an employee can periodically fall below the $30/month requirement and still be considered a "tipped employee." 29 C.F.R. § 531.57. In any event, the employer must pay at least $2.13 an hour in direct wages.

4. <u>Incidental and Related Tasks</u>

If an employee is engaged in duties for which tips are received as well as duties for which tips are not received, the issue of whether the tip credit can only be taken for the time spent performing tipped duties arises. The DOL regulation that addresses this circumstance, 29 C.F.R. § 531.56(e), provides that so long as a tipped employee is doing work related to the tipped duties, a tip credit is permitted. The regulation, by way of example, references a waitress who spends part of her time cleaning and setting tables, toasting bread, making coffee and occasionally washing dishes or glasses. The employer of this waitress may take tip credit for all of these duties because the duties for which a tip is usually not received (setting tables, etc.) is related to the duties for which a tip usually is received (waiting tables). *See Pellon v. Bus. Representation Int'l, Inc.*, 528 F. Supp. 2d 1306, 1313 (S.D. Fla. 2007) (holding additional non-tipped duties skycaps performed to be incidental to their duties as skycaps where there was no "clear dividing line" between these duties and those that clearly were performed for tips), *aff'd*, 291 Fed. Appx. 310 (11th Cir. 2008); *Townsend v. BG-Meridian, Inc.*, 2005 U.S. Dist. LEXIS 45200, at *6-7 (W.D. Okla. 2005) (holding that the employer could apply the tip credit towards the time the plaintiff-waitress spent while performing cashier and phone receptionist duties, in addition to the time she spent serving tables, because such duties were "merely related duties incident to her waitress position"). *But see Dole v. Fred Bishop & Carol Bishop*, 740 F. Supp. 1221, 1228 (S.D. Miss. 1990) (finding that the time waitresses spent cleaning and preparing food before the restaurant opened was easily separable from the time spent performing waitressing duties and, therefore, the waitresses were entitled to the full statutory minimum wage during these periods of time).

DOL's Field Operations Handbook (*available at* http://www.dol.gov/whd/FOH/FOH_Ch30.pdf) contains guidelines for determining how much non-tipped work can be assigned to an employee before the employer can no longer take the tip credit for non-tipped duties. The Handbook (Section 30d00e) indicates that employees who spend more than 20% of their time on general preparation and maintenance work cannot be considered tipped employees for the time spent doing general preparation and maintenance.

In a 1985 opinion letter (Dep't of Labor, Wage & Hour Div., Op. Letter FLSA-854 (Dec. 20, 1985)), the Department addressed the issue further, stating that the tip credit could be taken for "preparation work or after hours clean-up if such duties are incidental to the waiter or waitress's regular duties and are assigned generally to the waiter/waitress staff. However, where the facts indicate that specific employees are routinely assigned to maintenance work or that tipped employees spend a substantial amount of time performing general preparation work or maintenance, we would not approve a tip credit for hours spent in such activities." Several years later, in 1988, DOL's Handbook contained the 20% rule, which defined when general preparation or maintenance work had become substantial.

In *Fast v. Applebee's Int'l, Inc.*, 2009 U.S. Dist. LEXIS 67564 (W.D. Mo. Mar. 4, 2010), *appeal docketed*, No. 10-1725 (8th Cir.), the principal contention is Applebee's argument that the district court incorrectly used a task-based analysis rather than an occupation-based analysis

in determining whether plaintiff-bartenders were tipped employees. In its opening brief to the Eighth Circuit, Applebee's argues that the FLSA's tip credit requires an occupation-based analysis. Applebee's relies upon the language of the statute (§ 203(t)), which refers to "an occupation" as well as the record-keeping regulation (29 C.F.R. §516.28(a)(4) and (5)), which also uses the terminology "occupation."

5. Deductions

Tip credits are subject to the same deductions from wages as normal, non-tip wages. Deductions to cover cost of transaction charges of tips paid by credit card (as opposed to tips left in cash) are allowed. *Myers v. Copper Cellar Corp.*, 192 F.3d 546, 554 (6th Cir. 1999) ("The employer has an obvious legal right to deduct the cost of converting the credited tip to cash."); *Gillis v. Twenty Three East Adams Street Corp.*, 2006 U.S. Dist. LEXIS 12994 (N.D. Ill. Mar. 6, 2006) (ruling that pub did not violate FLSA by deducting from tips received by server an amount no greater than necessary to reimburse the pub for its expenses in processing credit card tip collections). Where tips are charged on a credit card and the employer must pay the credit card company a percentage on each sale, then the employer may pay the employee the tip, less that percentage. This charge on the tip may not reduce the employee's wage below the required minimum wage. The amount due the employee must be paid no later than the regular pay day and may not be held while the employer is awaiting reimbursement from the credit card company.

In *Reich v. Priba Corp.*, 890 F. Supp. 586 (N.D. Tex. 1995), the district judge posited, following a bench trial, that the employer had failed to prove that its standard 20% deduction from its waitresses' credit card tips (*see id.* at 595) was reasonably compensatory. The trial bench stated:

> "The court also concludes that Cabaret Royale failed to satisfy its burden of proving that the deductions from the waitresses' tips for credit card processing fees were reasonable. Cabaret Royale presented no documentation or records to support its contention that a percentage of the withholding covered the reasonable costs of credit card processing. Cabaret Royale's arrangement with the waitresses appears to be nothing more than an impermissible shift to its employees of its costs of doing business. The FLSA does not permit an employer to transfer to its employees the responsibility for the expenses of carrying on an enterprise."

Id. at 596 (citations omitted). Accordingly, proof that the employer's standard deduction from its employees' credit card tips reasonably compensated the employer only for no more than the overall costs of processing credit card tips, rather than other costs of doing business, would have safeguarded the employer's statutory tip credit.

A compulsory charge for service, for example, 15% of the bill, is not a tip. Such charges are part of the employer's gross receipts. Where service charges are imposed and the employee

receives no tips, the employer must pay the entire minimum wage and overtime required by the Act.

6. Notice Requirements

The FLSA requires that employees be informed of how tips will be credited toward minimum wage and that all tips be retained by employees. In *Kilgore v. Outback Steakhouse*,160 F.3d 294 (6th Cir. 1998), the Sixth Circuit held that providing employees with a tip policy page explaining how tips would be credited toward minimum wage is sufficient to meet the notice requirement for tip credits. The court remanded the case with respect to three employees who claimed they had either not been given notice or been discouraged from reading the notice.

7. Tip Pooling

The FLSA provides for tip pooling—employees' contributing their tips to a general pool which is then shared by other employees. 29 U.S.C. § 203(m); *see also* 29 C.F.R. § 531.54. Management can require employees to participate in a tip pool; but, if it does so, it must inform the employees of the FLSA's tip pooling provisions. *Kilgore v. Outback Steakhouse*, 160 F.3d 294, 303-04 (6th Cir. 1998) (holding that Outback was permitted to require its waiters to pool tips with hosts). *Cf. Leighton v. Old Heidelberg, Ltd.*, 219 Cal. App. 3d 1062 (Cal. Ct. App. Apr. 24, 1990) (holding that a mandatory tip pooling policy was not prohibited by California statute, promoted fairness, and ensured an equitable distribution of tips). Tip pooling differs from tip sharing. Tip sharing occurs when an employee earning tips voluntarily shares them with other employees. For example, a waiter voluntarily splitting his tips with a busboy/girl and bartender constitutes tip sharing. There are no regulations relating to voluntary tip sharing between employees. *Rousell v. Brinker International, Inc.*, 2008 U.S. Dist. LEXIS 52568, at *75 (S.D.Tex. July 9, 2008) (holding that employees may share tips with other workers who are not customarily and regularly tipped if they do so "free from any coercion whatever and outside any formalized arrangement or as a condition of employment"); WH Admin. Op. (Oct. 26, 1989); WH Admin. Op. (Mar. 26, 1976).

The *Kilgore* court explained:

> Hosts at Outback are "engaged in an occupation in which they customarily and regularly receive tips" because they sufficiently interact with customers in an industry (restaurant) where undesignated tips are common. Although the parties dispute exactly how hosts spend their time working at Outback, hosts do perform important customer service functions: they greet customers, supply them with menus, seat them at tables, and occasionally "enhance the wait." Like bus persons, who are explicitly mentioned in 29 C.F.R. § 531.54 as an example of restaurant employees who may receive tips from tip outs by servers, hosts are not the primary customer contact but they do have more than de minimis interaction with the customers. One can distinguish hosts from restaurant employees like

> dishwashers, cooks, or off-hour employees like an overnight janitor who do not directly relate with customers at all. Additionally, the fact that Outback prohibits hosts from receiving tips directly from customers provides some evidence that Outback hosts work in an occupation that customarily and regularly receives tips.

160 F.3d 294, 301-302 (6th Cir. 1998) (brackets and ellipses omitted; quotations in original).

In order for mandatory tip pools to pass muster under the FLSA, they must meet the following two requirements.

1. Participating employees must customarily and regularly receive tips, such as waiters, waitresses, bellhops, counter personnel (who serve customers), busboys/girls and service bartenders. Only those tips that are in excess of tips used for the tip credit may be contributed to a pool. Tipped employees cannot be required to contribute a greater percentage of their tips than is customary and reasonable. *Kilgore v. Outback Steakhouse*, 160 F.3d 294, 301 (6th Cir. 1998) (holding that hosts could participate in a tip pool because they were "engaged in an occupation in which [they] customarily and regularly received tip" although they were not allowed to personally accept tips); *Zhao v. Benihana, Inc.*, 2001 U.S. Dist. LEXIS 10678 (S.D.N.Y. May 7, 2001) (holding that a manger's disciplining of a plaintiff-employee for violating the tip pooling agreement between the servers and the chefs indicated that management "instituted or adopted the tip sharing agreement as a matter of restaurant policy and that the tip pool was therefore not voluntary" and thus in violation of the FLSA because it was mandatory and included ineligible employees); *Bonham v. Copper Cellar Corp.*, 476 F. Supp. 98, 101-02 (E.D. Tenn. 1979) (finding a tip pool arrangement was mandatory and, therefore, invalid because the managers urged waitresses to share 15 percent of their wages with bartenders, busboys, and kitchen personnel (non-tipped employees) and spoke personally with waitresses when they did not comply); *Marshall v. Krystal Co.*, 467 F. Supp. 9, 13 (E.D. Tenn. 1977); *Elkins v. Showcase, Inc.*, 704 P.2d 977, 989 (Kan. 1985). *See also* Dep't. of Labor Wage and Hour Div., Op. Ltr. 1997 DOLWH LEXIS 55, at *4 (Nov. 4, 1997) (suggesting that a tip pool is invalid when a tipped employee is required, as a condition of his or her employment, to share tips with non-tipped employee); U.S. Department of Labor Wage And Hour Division, Field Operations Handbook, 30d04(c) (1988), *available at* http://www.dol.gov/esa/whd/foh/index.htm. Some courts have placed significance on whether an employee regularly interacts with customers in determining whether an employee is eligible to participate in a tip pool. *Myers v. Copper Cellar Corp.*, 192 F.3d 546, 550 (6th Cir. 1999) (finding that salad preparers could not participate in a tip pool because they did not have any direct contact with diners, could not be seen by patrons, and had duties akin to those classified as food preparation or kitchen support work); *Elkins v. Showcase, Inc.*, 704 P.2d 977, 989 (Kan. 1985) (holding that bartenders who were located behind a wall had no interaction with customers were not regularly tipped employees who could participate in a tip pool arrangement and,

therefore, the employer could not utilize the tip credit for those employees). On the other hand, other courts have not placed the same significance on customer interaction and have held that employees who do not interact with customers can participate in tip pools. *Lentz v. Spanky's Rest. II, Inc.*, 491 F.Supp.2d 663 (N.D. Tex. 2007) (noting that nothing in the tip credit provision requires employees who participate in a tip pool to have direct interaction with customers and holding that "expediters," who helped prepare plates in the kitchen but did not interact with customers, could participate in the tip pool); *Louie v. McCormick & Schmick Rest. Corp.*, 460 F. Supp. 2d 1153, 1163 (C.D. Cal. 2006) (holding that restaurants may require servers to share tips with bartenders, regardless of whether bartenders provide direct or indirect services to a particular server's customers); *Etheridge v. Reins Int'l California, Inc.*, 172 Cal. App. 4th 908 (Cal. Ct. App. Mar. 27, 2009) (holding that employees who did not provide "direct table service" could still participate in tip pools). *See also* 29 U.S.C. § 203(m) (2009) (there is no explicit requirement in the tip credit provision that employees who participate in a tip pool interact directly with customers).

2. Management employees must not participate in the tip pool. *Morgan v. SpeakEasy*, 625 F. Supp. 2d 632 (N.D. Ill. Sept. 20, 2007); *Dominguez v. Don Pedro*, 2007 U.S. Dist. LEXIS 6659 (N.D. Ind. Jan. 25, 2007); *Chung v. New Silver Palace Rest., Inc.*, 246 F. Supp. 2d 220 (S.D.N.Y. 2002) (holding that defendants violated the statutory requirement that tipped employees be allowed to retain all tips received by requiring plaintiffs to share tips with individuals the court found to be employers); *Ayres v. 127 Rest. Corp.*, 12 F. Supp. 2d 305 (S.D.N.Y. 1998) (holding that when a portion of tips went to a restaurant's general manger through a tip pooling arrangement, the employer did not meet the FLSA's requirement that "all tips received by an [an] employee have been retained by an employee").

The Ninth Circuit in *Misty Cumbie v. Woody Woo, Inc.*, 2010 U.S. App. LEXIS 3686 (Feb. 23, 2010), held that a tip pooling arrangement in which the majority of the tips were redistributed to the kitchen staff was valid under the FLSA. Key to this decision was the fact that the employer paid the servers an hourly wage great equal or greater than the state minimum wage. The court found the fact that the employer was not taking a "tip credit" to be the decisive factor in upholding the tip pool. *Id.* at *10.

The FLSA does not mandate how tip pool contributions should be split among participating employees. However, the Department of Labor has stated that a required tip pool contribution of more than 15% of an employee's tips may not be valid. *Elkins v. Showcase, Inc.*, 704 P.2d 977, 981 (Kan. 1985) (following WH Admin. Op. (Sept. 5, 1978)). On the other hand, the Sixth Circuit has held that there is no statutory or regulatory authority for the DOL's position that a more than 15% contribution to tip pool is excessive. *Kilgore v. Outback Steakhouse*, 160 F.3d 294 (6th Cir. 1998) ("The [c]ourt can find no statutory or regulatory authority for the Secretary's

opinion that contributions in excess of 15% of tips or 2% of daily gross sales are excessive"). *See also Dole v. Continental Cuisine*, 751 F. Supp. 799 (E.D. Ark. 1990).

For purposes of tip credit and minimum wage calculations, pooled tips are considered to be the property of the employees receiving them, not the employees who contributed them to the tip pool. 29 C.F.R. §531.54.

If an employee challenges the validity of a tip pool, the employer has the burden of proving it complies with the FLSA. *Barcellona v. Tiffany English Pub, Inc.*, 597 F.2d 464, 467 (5th Cir. 1979) (holding that TGI Friday's restaurant had the burden to prove a valid tip pool arrangement upon the questioning of the waiters who believed they were being denied the statutory minimum wage).

8. **Importance of State Law**

The analysis of tip issues does not end with the FLSA. Practitioners need to research applicable state law. This portion of this paper is not intended to be exhaustive regarding state rules pertaining to tips, but rather to underscore the admonition that there may be an applicable state law that needs to be considered.

California, as early as 1917, enacted legislation prohibiting employers from taking any portion of an employee's tips. That 1917 law was declared unconstitutional, and it was not until 1975, after repeated unsuccessful attempts, that the California legislature enacted legislation prohibiting the practice of "tip credits." The California Labor Code § 351 offers greater employee protections than the FLSA, and the courts have ruled so far that the FLSA does not "preempt" the California rules. *See*, *e.g.*, *Tidewater Marine Western, Inc. v. Bradshaw*, 14 Cal. 4th 557, 567 (1996); *Skyline Homes, Inc. v. Dep't of Indus. Relations*, 165 Cal. App. 3d 329, 250-251 (1985).

California has held that "tip pooling," so long as it is "fair and reasonable," is not an illegal "taking" of the employee's "sole property." *Leighton v. Old Heidelberg, Ltd.*, 219 Cal. App. 3d 1062 (1990).

The California Supreme Court is considering whether there is a private right of action under § 351. *Lu (Louie Hung Kwei) v. Hawaiian Gardens Casino, Inc.*, 170 Cal. App. 4th 466 (Cal. Jan 22, 2009).

In a California case against Starbucks, the California court overturned the trial court's ruling that the company pay nearly $106 million to some 120,000 baristas because supervisors were unlawfully allowed to share tips. *See Chau v. Starbucks Corp.*, 174 Cal. App. 4th 688, 2009 Cal. App. LEXIS 870 (Cal. Ct. App. June 2, 2009).

In New York, no portion of a mandatory service charge may be distributed outside of the non-supervisory wait staff if the customer reasonably believed that the charge constituted a

gratuity. *See*, *e.g.*, *Samiento v. World Yacht, Inc.*, 10 N.Y.3d 70 (N.Y. Feb. 14, 2008). In New York, Judge Swain of the Southern District granted summary judgment to Starbucks in an action similar to the *Chau* case from California. *In re Starbucks Employee Gratuity Litig.*, 264 F.R.D. 67 (S.D.N.Y. Dec. 16, 2009). In this case, the plaintiff baristas contended that Starbucks had violated the New York state wage and hour statutes by splitting tips intended for baristas with shift supervisors, handing out tips on a weekly basis instead of a per-shift basis, and failing to distribute tips to baristas-in-training.

The Connecticut Supreme Court, in a case involving class certification, had as the substantive basis a dispute involving "tip credit" under the Connecticut wage statute. *See Palmer v. Friendly Ice Cream Corp.*, 285 Conn. 462 (Feb. 12, 2008).

9. **Taxes**

Employers are entitled to a credit on social security and Medicare taxes paid on tipped income that brings an employee's hourly rate over the standard minimum wage. This credit only applies to tips received by food and beverage employees. The tip credit is added to an employer's profits and is thus subject to income tax liability. *See* Ronald L. Noll, *Accountant's Corner: Take Advantage of the Tip Credit*, *available at* http://www.restaurantreport.com/departments/ac_tipcredit.html (last visited June 10, 2010); Credit for Portion of Employer Social Security Paid with Respect to Employee Cash Tips (IRC 45 B Credit), *available at* http://www.irs.gov/businesses/small/industries/article/0,,id=98463,00.html (last visited June 10, 2010).