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# Understanding the FLSA's Tip Credit and Tip Pooling Rules

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Many employees in the service sector earn most of their compensation through tips rather than wages. Under certain circumstances, employers are allowed to claim a "tip credit" toward satisfying state and federal minimum wage laws. This means that an employee's tips are credited toward the employer's obligation to pay the minimum wage to that employee (see ¶553 of the *Guide*).

However, the tip credit rules of the Fair Labor Standard Act (FLSA) are full of traps for the unwary. The FLSA also has rules concerning tip pools, which only complicate matters further.

Increasingly, plaintiffs' lawyers are challenging employers' use of the tip credit and tip pools through collective action lawsuits that are costly to defend and threaten employers with significant legal exposure. For employers in the service sector, understanding the FLSA's tip credit and tip pooling rules is therefore vital to ensuring compliance with the FLSA and avoiding liability.

### Why Use the Tip Credit and Tip Pooling?

The obvious advantage to using the FLSA's tip credit is that it allows employers to pay employees significantly less in direct wages and effectively take credit for the tips that customers pay to employees. Employers may also claim a credit for the Social Security and Medicare taxes paid on the tip income of employees who receive tips for serving food or beverages for consumption.

Allowing employees to pool their tips offers other advantages. Tip-pooling allows employers to claim a tip credit for employees who might not otherwise meet the definition of a tipped employee. Tip pooling also provides employees with what they may regard as a fairer distribution of wages and can promote teamwork among employees rather than an "every man for himself" mentality.

### Key Definitions

To understand how the tip credit and tip pooling work, some definitions are in order.

- A **tipped employee** is any employee engaged in an occupation in which the individual customarily and regularly receives at least $30 per month in tips (29 U.S.C. § 203(t)).
- A **tip** is "a sum presented by a customer as a gift or gratuity in recognition of some service performed by him" (29 C.F.R. §531.52.). Although this definition may seem obvious, tips must be distinguished from compulsory service charges. Such compulsory charges are not considered tips and, even if distributed to employees, cannot be used to satisfy the tip credit (29 C.F.R. § 531.55). However, if customers provide additional monies above the compulsory service charge as a gratuity, these additional amounts are treated as tips (*Id.*).
- Banquet halls and restaurants that cater to foreign tourists (who oftentimes are unaware of American tipping customs) often impose **compulsory service charges**. Using these charges to offset the tip credit

**See *Tip Credit*, p. 2**

## *Tip Credit* (continued from p. 1)

is unlawful and can result in significant liability. However, if the employer is willing to forego the tip credit, the employer may distribute some or all of the compulsory service charges to his employees. These amounts may be used in their entirety to satisfy the minimum wage requirements. However, the regulations suggest, and some cases hold, that in order for the employer to use nondiscretionary service charges to satisfy the employer's minimum wage obligation, the employer must account for such receipts in the same manner as other revenues, i.e., such tips must be included in gross revenues subject to sales and income taxes (*e.g., Chan v. Triple 8 Palace, Inc.*, 2006 WL 851749, *6-7 (S.D.N.Y. 2006)).

### Dual Occupations Versus Incidental Duties

In some situations, an employee is employed in dual occupations. For example, a hotel maintenance employee may also be employed as a waiter. In such a case, the employee, if he customarily and regularly receives at least $30 per month in tips, is only a tipped employee for the time he works as a waiter. The employer may not claim a tip credit for the time the employee spends performing maintenance duties.

On the other hand, an employer may claim a tip credit for the time an employee spends on duties that are related to the tipped occupation, even though those duties do not directly generate tips. For example, an employer may claim a tip credit for the time that a waitress spends cleaning and setting tables, making coffee and occasionally washing dishes or glasses, provided that such duties are incidental to the waitress's regular duties and are regularly assigned to waitresses at that establishment (29 C.F.R. §531.56(e); FOH §30d00(e); DOL Fact Sheet #15).

The line between non-tipped work and non-tipped duties incidental to a tipped occupation is nebulous. Courts rely upon several criteria, which often point in different directions, and the cases are difficult to reconcile based on the facts recounted in the reported decisions. For example, in *Fast v. Applebee's International, Inc.* (2007 WL 1309680 (W.D. Mo. 2007)), in which a bartender claimed that his job included cleaning, restocking and taking inventory; washing fruit and filling baskets; restocking juices; emptying garbage cans and wiping down the bar and bar chairs, the court suggested that the employer must account for non-tipped work virtually on a minute-by-minute basis. In contrast, in *Pellon v. Business Representation Int'l, Inc.* (528 F.Supp.2d 1306 (S.D. Fla. 2007)), the court held that apportioning skycaps' jobs between tipped and non-tipped tasks was not required when it was shown that doing so was infeasible and would require constant surveillance.

### How the Tip Credit Works

The "direct wage" is the minimum amount an employer must pay directly to a tipped employee for whom the employer is claiming a tip credit. That amount is currently $2.13 per hour (DOL Fact Sheet #15). An employer may claim a tip credit for the remaining amount up to the minimum wage.

> In order for an employer to claim a tip credit, the employee must be permitted to retain his tips. The only exception is when the employee participates in a valid tip pool.

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 (*Davis v. B&S, Inc.*, 38 F. Supp. 2d 707, 712 (N.D. Ind. 1998); Fact Sheet #15). The current federal minimum wage is $6.55 per hour. Therefore, in states without a minimum wage or in states in which the minimum wage is less than the federal minimum wage (see ¶150A of the *Guide*), an employer must ensure that the tipped employee receives in tips the difference between the direct wage (usually $2.13) and $6.55, or $4.42 per hour, each workweek. If the employee receives less in tips, the employer must make up the difference by paying additional direct wages to the employee.

Some states require a higher minimum wage and a higher direct, or tipped, wage than the minimums required under federal law. In those states, the tipped employee must receive the state minimum wage when the direct wage and tips received are combined. A few states do not allow employers to claim a tip credit. Employers should be aware of the applicable laws in each state in which their tipped employees work.

### Additional Requirements

Even if all the other requirements for taking a tip credit are satisfied, an employer may not claim a tip credit to reduce its minimum wage obligation unless it has given the employee notice that it is crediting his tips against its minimum wage obligation (29 U.S.C. §203(m)).

However, current U.S. Department of Labor (DOL) regulations do not address what constitutes sufficient notice, and case law addressing this issue does not provide a uniform rule. In *Pellon*, the court held that the posting

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## *Tip Credit* (continued from p. 2)

of a standard DOL poster containing the customary statement of tipped employees' rights, coupled with pay stubs showing the reduced minimum wage and reported tips, constituted sufficient notice (528 F. Supp. 2d at 1309-12). DOL recently proposed several revisions to its regulations implementing the FLSA (see story, p. 14), including a change related to the tip credit notice. DOL's proposed amendment to 29 C.F.R. §531.59 requires that the notice "inform[] … employees that [the employer] intends to avail itself of the tip wage credit" (73 Fed. Reg. 43654, 43667, July 28, 2008). Consequently, a better practice is for the employer to give written notice to each tipped employee that the employee will be receiving a reduced minimum wage, and that the employer will be crediting the employee's tips against its minimum wage obligation.

In order for an employer to claim the tip credit, the employee also must be permitted to retain his tips. The employee cannot be required to share his tips with non-tipped employees or to "kick back" tips to his employer. The only exception to this retention requirement is when an employee participates in a valid tip-pooling arrangement (29 U.S.C. §203(m)).

### How Tip-Pooling Works

The FLSA expressly permits employees to pool their tips (29 U.S.C. §203(m); 29 C.F.R. §531.54). Moreover, an employer can *require* employees to pool their tips (*Kilgore v. Outback Steakhouse of Florida, Inc.*, 160 F.3d 294, 303-04 (6th Cir. 1998)). Employers are generally free to determine the tip-pooling arrangement among the employees in the tip pool. There are two important exceptions, however.

First, a tip pooling arrangement is invalid if an employee must relinquish more than a "customary and reasonable" amount of tips to the pool. For DOL enforcement purposes, the Wage and Hour Division does not question contributions to a pool not exceeding 15 percent of an employee's tips. (DOL Field Operations Handbook (FOH) §30d04(a) (1988); Wage and Hour Opinion Letter, Sept. 5, 1978, WH-468). However, the requirement that the "tip out" be no more than is "customary and reasonable" is not found in the statute; its source is a DOL opinion letter (Wage and Hour Opinion Letter, March 26, 1976, WH-380). Several courts have refused to recognize it as law (see, e.g., *Kilgore,* 160 F.3d at 302-03), and DOL's proposed regulation (29 C.F.R. §531.54) eliminates any ceiling on the "tip out," but requires that employees be informed of the amount of the tip pool contribution (see 73 Fed. Reg. 43667).

Second, only those employees working in occupations in which employees customarily and regularly receive tips can participate in a tip pool. These occupations include (but are not limited to) waiter, bellhop, busboy, counter personnel and service bartender (FOH §30d04(a)). Conversely, employees working in occupations in which employees do *not* customarily and regularly participate in tip pooling cannot participate in a tip pool. These occupations include (but are not limited to) janitor, dishwasher, chef, cook and laundry room attendant (*Id.*).

While these definitions are somewhat circular, the key to understanding whether an employee in a particular occupation is eligible to participate in a tip pool is whether the occupation entails regular interactions with customers. If so, persons employed in that occupation will likely be deemed eligible to participate in a tip pool. For example, courts have held that hosts and hostesses, and *maîtres d' hôtel* were eligible to participate in a tip pool, whereas salad mixers and kitchen helpers have been deemed ineligible (*Myers v. Copper Cellar Corp.*, 192 F.3d 546 (6th Cir. 1999) (salad mixers were not eligible to participate in a tip pool); *Kilgore*, 160 F.3d at 301-02 (hosts and hostesses were eligible); *Lixin Zhao v. Benihana, Inc.*, 2001 WL 845000 (S.D.N.Y. 2001) (kitchen helpers were ineligible); *Dole v. Continental Cuisine, Inc.*, 751 F. Supp. 799 (E.D. Ark. 1990) (a maître d' was eligible)).

### Tip Pools Restricted to Employees

Employers are also ineligible to participate in a tip pool. The FLSA's definition of an "employer" "includes any person acting directly or indirectly in the interest of an employer in relation to an employee" (29 U.S.C. §203(m)). Courts generally use the "economic reality test" to determine whether an individual is an employer. This test inquires into whether the individual (1) has the power to hire and fire employees, (2) supervises and controls employee work schedules or conditions of employment, (3) determines the rate and method of employees' pay, and (4) maintains employment records.

The greater number of these factors present, the more likely it is that the individual will be deemed to be an agent of the employer and thus ineligible to participate in the tip pool (see, e.g., *Chung v. New Silver Palace Restaurant, Inc.*, 246 F. Supp. 2d 220 (S.D.N.Y. 2002) ("black jackets" were employers, where they included shareholders and board members of the restaurant, exercised hiring and firing powers and had direct supervisory power over the waiters); *Ayres v. Restaurant Corp.*, 12 F. Supp. 2d 305 (S.D.N.Y. 1998) (the general manager of the restaurant was ineligible to participate in the tip pool where he had authority to suspend, terminate and hire,

**See *Tip Credit*, p. 4**

## *Tip Credit* (continued from p. 3)

had responsibility for the restaurant's budget, and received a weekly salary irrespective of his hours worked)).

### Overtime Pay for Tipped Employees

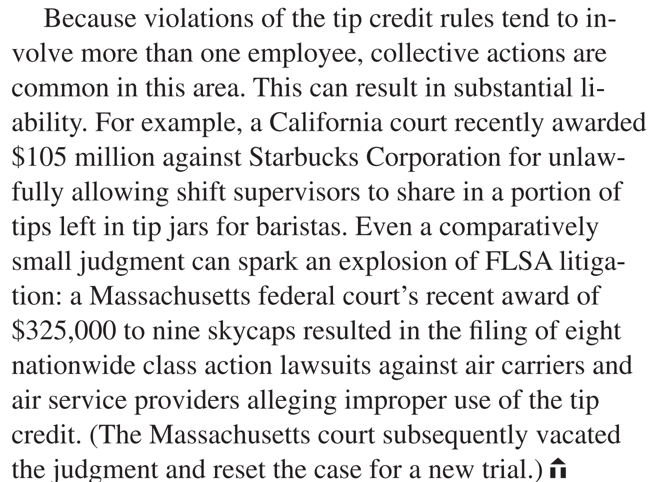
Calculation of the overtime premium required to be paid to tipped employees is counterintuitive, and therefore often improperly done. For non-tipped employees, overtime pay is calculated as one and one-half the regular wage paid for non-overtime hours (see Tab 500 of the *Guide*). But for tipped employees, the overtime wage is not one and one-half times the tipped wage, as one might think. Rather, the *full* minimum wage is multiplied by one and one-half, and that product is reduced by the same tip credit used for computing the non-overtime wage. For example, if a tipped employee is paid a $2.13 per hour wage, the federal tip credit currently is $4.42 ($6.55 – $2.13). For overtime hours, tipped employees must be paid a wage of $5.41 (($6.55 x 1.5) – $4.42).

### The Cost of Violations

Violating the FLSA's tip rules can expose an employer to significant damages.

Violations of the tip-pooling rules will "poison" the tip pool and subject an employer to liability for all employees who were participants in the tip pool. Similarly, if an employer misclassifies non-tipped employees as tipped employees, or fails to give notice of the tip credit to tipped employees, liability will result for all affected employees.

An employer's liability for violating the tip credit and tip pooling rules is measured by the difference between the tip credit and the minimum wage for up to three years under federal law, and frequently longer under state minimum wage laws. Liquidated damages equal to the amount of back pay (see ¶922 of the *Guide*) and attorney's fees (see ¶924 of the *Guide*) also may be part of an employee's award.



Because violations of the tip credit rules tend to involve more than one employee, collective actions are common in this area. This can result in substantial liability. For example, a California court recently awarded $105 million against Starbucks Corporation for unlawfully allowing shift supervisors to share in a portion of tips left in tip jars for baristas. Even a comparatively small judgment can spark an explosion of FLSA litigation: a Massachusetts federal court's recent award of $325,000 to nine skycaps resulted in the filing of eight nationwide class action lawsuits against air carriers and air service providers alleging improper use of the tip credit. (The Massachusetts court subsequently vacated the judgment and reset the case for a new trial.)

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