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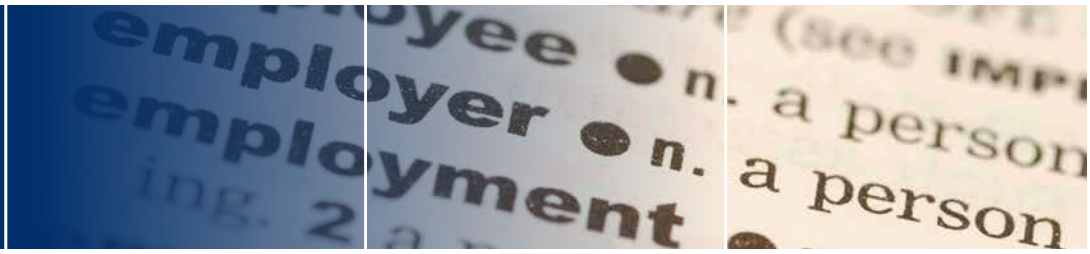


NEWSLETTER
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# Tips, Tip Pooling and Service Charges: Developments & Guidelines

Mandatory service charges and their distribution among waitstaff have plagued the Hospitality industry for years. Federal courts interpret federal laws differently, and states have enacted their own statutes that keep employers in constant uncertainty, depending on where they are located. Also, tip pooling arrangements have been a regular part of many restaurant operations and are generally allowed by both federal and state law. However, there are limitations as to who can participate and how much can be contributed to the tip pool. Following is an overview of the guidelines involving tips, tip pooling and service charges and some suggestions on how to stay compliant.

## TIP VERSUS MANDATORY SERVICE CHARGE

In a ruling issued in June 2012, the Internal Revenue Service clarified the difference between a tip and a service charge for tax purposes under the Federal Insurance Contributions Act. The IRS determined that automatic gratuities (a percentage automatically added to a restaurant bill) are service charges rather than tips for tax purposes. Revenue Ruling 2012-18 also determined that to the extent any portion of a "service charge" is distributed to an employee, it is wages for FICA tax purposes. *Continued*


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Generally, the burden of reporting tips falls on the employee. Employees who receive more than $20 in cash tips (cash, debit/credit cards) per month are required to report the tips to their employers by the tenth day of each month. The employer is then required to withhold FICA taxes, similar to withholding for non-tip wages. An employer is not liable for its share of FICA taxes if the employee fails to report tips.

However, effective January 1, 2014, employers are required to treat mandatory gratuities as "service charge wages" instead of tips. This directly affects overtime calculations as well as an employer's responsibility to report and pay FICA taxes.

Under the new guidelines, the IRS stated that differentiating between tips and wages requires a factual determination considering all the circumstances. The IRS will generally categorize a payment as a tip (versus a wage) when (1) the payment is made free of compulsion, (2) the customer retains the right to determine the amount, (3) payment is not subject to negotiation or employer policy and (4) the customer determines who gets payment.

As a result, automatic gratuities or service charges are no longer considered tips. Customers do not have a choice whether or not to leave a gratuity and are forced to leave a specified amount set by the employer. Such mandatory gratuities when distributed to employees by the business are considered wages and therefore are not eligible for the FICA Tip Credit (45B Credit).

Also, since automatic gratuities and service charges are not tips, they cannot be included in the tip amount on which social security and Medicare taxes are paid, which takes some tax credit off the table for restaurants. This credit is claimed on Form(s) 8846 and 3800.

However, where a restaurant provides a customer a receipt with recommended tipping amounts, i.e., 15%, 18% and 20%, the IRS does not classify the amount left as wages because the customer is the one determining the amount, and does so free of compulsion. Therefore, this situation would support a finding that this is truly a tip and not considered wages.

Absent choice by the customer, an automatic gratuity when paid by the restaurant to the employee is considered part of the employee's wages. This means the burden rests on the employer to incorporate automatic gratuities as part of the employees' wages as opposed to relying on the employees to report their tips. Service charges/automatic gratuities are considered part of the employees' overall rate of pay. As such, in states such as California where a member of the waitstaff works more than 40 hours in a week or 8 hours in a day and receives a portion of the automatic gratuities, this amount must be factored into the total wages earned and factored into that day's or week's regular rate of pay (i.e., total wages ÷ 8 or ÷ 40). It is this figure that is used to determine the overtime rate of pay (1.5 times the regular rate of pay) for any overtime earned.

This means employers now have the additional burden to change their pay systems and calculate automatic gratuities as part of employees' wages and use them to determine the regular rate of pay for a particular day or week for purposes of correctly calculating overtime. Therefore, employers must pay close attention to avoid the underpayment of overtime wages.

## FEDERAL LAW REGARDING TIP POOLING

The federal law on tip pooling adopts standards that are protective of employees' right to tips.

The Fair Labor Standards Act (FLSA) permits employer-mandated tip pools among employees who "customarily and regularly" receive tips, such as waiters, waitresses, bellhops, bussers and service bartenders. The FLSA makes clear that employees such as chefs, cooks, janitors and dishwashers are not allowed to share in the money contributed to a tip pool. A court in one case has held that hosts and hostesses who greet customers and perform some table attendance duties might be included in a tip pool. However, this holding is not all-encompassing, so a case-by-case analysis needs to be applied to determine applicability. *Continued*

The FLSA forbids any arrangement where any part of the tip received becomes the property of the employer. A tip is the sole property of the tipped employee or employees appropriately participating in the tip pool.

The Department of Labor (DOL) also mandates that the pooling arrangement must be "customary and reasonable" and cannot require employees to contribute a greater percentage of their tips other than what is customary and reasonable. Although there is no definition or exact percentage of what the DOL deems "customary and reasonable," the Wage and Hour Division has found contributions of 15% or less of an employee's tips to be acceptable. Contributions of greater than 15% are not statutorily forbidden but may require the employer to show that such a percentage is "customary and reasonable" for that community.

States also have similar definitions of allowable tip pooling. An issue of much interpretation and debate is whether employers may mandate that tips/gratuities be pooled and distributed among certain employees as a mechanism for ensuring that gratuities are shared by all employees in the "chain of customer service," also known as tip pools.

Tip pools, whether voluntary or mandatory, are generally permitted for restaurant employees so long as:

- Tip pool participants are limited to those employees who contribute to the chain of service bargained for by the patron
- No employer or agent of the employer takes or receives any part of the tips intended for employees
- The tips are distributed among the pool participants in a fair and reasonable manner.

Pooling tips for redistribution is not required, nor is a written agreement or policy required to allow a tip pool.

## "CHAIN OF SERVICE" ELIGIBILITY

However, the definition of "chain of service" has continued to be refined and to evolve with opinions by federal and state wage and hour divisions and the courts. For example, in 2005, California's Department of Labor Standards Enforcement issued an opinion regarding tip pools stating that employees eligible to participate in a tip pool includes anyone who contributes to the "chain of service bargained for by the patron, pursuant to industry custom." This opinion letter described the "chain of service" to include bussers, bartenders, hostesses, wine stewards and front-room chefs (e.g., chefs at a sushi bar or those who prepare food at the patron's table). The opinion reaffirmed that no employer or agent with the authority to hire or discharge any employee or supervise, direct or control the acts of employees may collect, take or receive any part of the gratuities intended for the employees as their own. In other words, despite any tip pool container, often seen at coffee shops, the owner(s), manager(s) or supervisor(s) of the business cannot participate in the tip pool, even if these individuals provide direct table service to a patron. This is the case even if the guest intended to leave the tip for an owner, manager, supervisor or agent of the business who actually provided service to the patron. Given the broad definition in the Labor Code, an agent could include a floor manager or shift supervisor if that person has the ability to direct or control the acts of employees.

However, recent court decisions have allowed shift supervisors in certain situations to share in gratuities. This was dealt with in lawsuits by Starbucks baristas as to the company's practice of permitting shift supervisors to share tips. At the Starbucks stores, the collective tip box was divided among the entry-level employees and the shift supervisors. A trial court in San Diego initially ruled that California law prohibited managers and supervisors from sharing such tips and awarded more than $105 million in damages. However, this decision was reversed, with the Court of Appeals holding that shift supervisors are eligible to share in the tip pool, reversing the lower court decision. The Court of Appeals found that shift supervisors performed the same tasks as baristas because their primary duty was to serve food and drinks. *Chau v. Starbucks, Corp.*, 174 Cal App 4th 688 (2009).

*Chau* has not been overturned and other states, including New York, cited to the *Chau* case to support allowing shift supervisors to participate *Continued*

in the tip pool based on their duties being more akin to those of baristas. *See, Barenboim v. Starbucks Corp.*, 2013 N.Y. Slip Op. 04754 (June 26, 2013), wherein New York's highest court found that, given they performed the same duties as baristas, shift supervisors could share in the tip pool. Therefore, there seems to be consistency among states as to the role of shift supervisors working at Starbucks. However, consistently courts have found assistant store managers should not be included in the tip pool because they have too many managerial duties, including hiring and firing, so as not to be classified as wait staff.

These cases have also brought up the concept of a customer service team (consisting of one or more entry-level employees and one or more shift supervisors) whose members rotated jobs throughout the day and spent most of their time performing the same customer service tasks, thereby supporting the Starbucks tip pooling arrangement. Generally, a customer who places a tip in a collective tip box was found to understand that it would be shared by all service employees, and these cases appear to be guiding law.

As to tip pooling, the industry has adopted a standard that distributes the majority of the pooled gratuities to waiters and waitresses, followed by a smaller percentage to bussers, and a still smaller percentage to other categories of employees who provide limited direct table service. There is no specific cap placed on the percentage of tips waiters and waitresses can be compelled to "tip out," but this guidepost will likely result in a tip pooling arrangement being viewed favorably.

## TIP CREDIT AND TIP POOLING

The most recent issue that has arisen involves who can share in the tip pool and whether "back of the house" employees such as dishwashers, food scrapers, chefs and cooks can share in the tip pool. Under the Federal Labor Standards Act (FLSA), the Department of Labor (DOL) has consistently taken the position that employees who do not provide direct service to the customer are not allowed to participate in a tip pool. This would mean that kitchen staff with no direct service contact would not be viewed as being valid participants to share in a tip pooling arrangement.

However, inconsistent interpretations of the FLSA among various appellate courts have created confusion for both employers and courts regarding the applicability of valid tip pools. One of the most interesting interpretations of the FLSA occurred in early 2010, when the Ninth Circuit Court of Appeals (which covers the states of California, Nevada, Oregon, Washington, Arizona, Alaska, Idaho, Montana and Hawaii) held that an employer could require servers to pool their tips with non-tipped kitchen and other "back of the house" staff, so long as a tip credit was not taken and the servers were paid minimum wage. *Cumbie v. Woody Woo, Inc.*, 596 F.3d 577 (9th Cir. 2010). According to the court, nothing in the text of the FLSA restricted tip pooling arrangements when no tip credit was taken; therefore, because the employer did not take a tip credit to reach the minimum wage, the tip pooling arrangement did not violate the FLSA.

In response, the DOL initially announced that in accordance with the *Woody Woo* decision, it would permit employers in the Ninth Circuit to impose mandatory tip pooling on employees who did not customarily and regularly receive tips. However, on April 5, 2011, the DOL issued regulations that directly conflicted with the holding in *Woody Woo*. At that time, it was unclear whether the DOL would enforce the new regulations against employers in the Ninth Circuit. In early 2012, the DOL clarified its position on tip pooling by fully rejecting the Ninth Circuit's decision in *Woody Woo*. Therefore, employers could no longer require mandatory tip pooling with "back of the house" employees. In conjunction with this announcement, the DOL issued an advisory memo directing its field offices nationwide, including those within the Ninth Circuit, to enforce its rule prohibiting mandatory tip pools that include such employees who do not customarily and regularly receive tips.

As a result, a challenge was filed in the federal District Court of Oregon by the Oregon Restaurant and Lodging Association and other hospitality groups challenging the DOL memorandum. *Continued*

This resulted in the decision in *Oregon Restaurant and Lodging Assn. v. Solis*, No. 3:12-cv-01261 (D. Or. June 7, 2013). The District Court held that the DOL exceeded its authority by issuing regulations on tip pooling in restaurants. The court stated that the language of section 203(m) of the FLSA is clear and unambiguous; it only imposes conditions on employers that take a tip credit. Quoting the Ninth Circuit's opinion in *Woody Woo*, the court explained that "[a] statute that provides that a person must do X in order to achieve Y does not mandate that a person must do X, period." As a result, this decision extended the *Woody Woo* holding allowing mandatory tip pools that include employees who do not normally receive tips so long as a tip credit was not taken to reach the minimum wage. This case has not been appealed to date and is good law subject to citation, especially in states located in the Ninth Circuit where no tip credit exists.

In response, the DOL Wage and Hour Division set forth clear guidelines on how to enforce its regulations in light of the recent decisions in the Ninth Circuit. The official *verbatim* position states as follows:

> In *Oregon Restaurant and Lodging Ass'n et al. v. Solis*, __ F. Supp. 2d __, 2013 WL 2468298 (D. Or. 2013), the U.S. District Court for the District of Oregon declared the Department's 2011 regulations that limit an employer's use of its employees' tips when the employer has not taken a tip credit against its minimum wage obligations to be invalid. As a result of that decision and the judgment entered in that case, at least until the resolution of any appeal that may be taken in this case, the Department is prohibited against enforcing its tip retention requirements against plaintiffs (which include several associations, one restaurant, and one individual) and members of the plaintiff associations that can demonstrate that they were a member of one of the plaintiff associations in this litigation on June 24, 2013. The plaintiff associations in the Oregon litigation were the National Restaurant Association, Washington Restaurant Association, Oregon Restaurant and Lodging Association, and Alaska Cabaret, Hotel, Restaurant, and Retailer Association. As a matter of enforcement policy, the Department has decided that it will not enforce its tip retention requirements against any employer that has not taken a tip credit in jurisdictions within the Ninth Circuit while the federal government considers its options for appeal of the decision. The Ninth Circuit has appellate jurisdiction over the states of California, Nevada, Washington, Oregon, Alaska, Idaho, Montana, Hawaii, and Arizona; Guam; and the Northern Mariana Islands.

As a result of this statement, a company located in the jurisdiction of the Ninth Circuit that does not take a tip credit appears to have the authority to allow employees who are not directly in the line of service to be part of a tip pool arrangement.

## PRACTICAL GUIDELINES FOR COMPLIANCE

Given the recent decisions, the definitions of "agent" and who is "in the chain of service" will continue to be litigated and defined by administrative agencies and ruled on by courts. However, in light of current case law, baristas and shift supervisors who do not have the authority to hire and fire and whose duties are primarily the same as servers likely can share in tip pools. Also, it is reasonable given the holdings in *Woody Woo* and *Oregon Restaurant and Lodging Assn*. that a tip pool would include "back of the house" kitchen staff given the industry standard that all restaurant employees contribute to the chain of service to a patron in establishments located in the Ninth Circuit in jurisdictions that do not allow a tip credit. A fair reading of the opinions would support a tip pooling arrangement that includes nontraditional service employees such as chefs, cooks, bussers and even dishwashers as being allowed to be part of a tip pool if located in a state in the Ninth Circuit working for an employer that does not take a tip credit.

Another issue that is likely to be raised and should be monitored is developing a tip pooling arrangement that awards a greater percentage to the employees who provide direct service and a lower amount to the "back of the house" employees. *Continued*

Ways to limit liability on tip pooling claims could include:

- Only include employees who actually contribute to the chain of service and who per industry custom are subject to receiving tips. Such individuals typically include those who provide direct table service. However, the chain of service industry custom and the case law support allowing kitchen staff who have limited direct contact to receive a smaller percentage of the tip pool; the industry custom has evolved to recognize that these employees are essential to the chain of service.
- Rely more on what the employee actually does in his/her job versus a job title. For example, an employee carrying the title of "waitress" whose only job is to prepare food outside the view of patrons or who has no personal contact with patrons will likely not be properly included in a tip pool or should receive a lower percentage than an employee who actually has direct interaction with the patron.
- Do not distribute any portion of a tip pool to any manager or supervisor, even if that manager or supervisor provides direct table service and/or the tip was left by the patron specifically for that individual.
- Make sure that the tip pool is distributed to participating employees in a reasonable manner, proportionate with the employees' direct interaction with the customers.

For more specific questions on these issues, it is important to consult competent legal counsel who understands both the Hospitality industry and wage and hour issues and can analyze those issues in relation to specific circumstances and policies.

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