



Service Charges Could Be Solution to Tip Credit Challenges: An Employer's 6-Step Guide

Insights

4.18.22

Hospitality employers who utilize the “tip credit” under federal wage and hour law may feel as if they operate with a bullseye on their backs given the multi-prong assault underway against the practice. Not only are you in danger of being hit with a costly lawsuit if you use the tip credit, but you can’t help but see the federal and state governments attacking the concept itself. But could there be an easy alternative hiding in plain sight that could lighten your burden and take that target off your back? A recent federal appeals court decision in a case involving the celebrity restaurant owner known as Salt Bae shows how the service charge could be a possible solution – and this Insight will provide a six-step blueprint should you decide to walk this alternative path.

Multi-Prong Attack Against the Tip Credit

Using the tip credit in this day and age could sometimes feel like fraught with danger, as various challenges seem to pop up each new day.

Lawsuits Remain a Constant Threat – and They’re Increasing

The odds of being targeted with a tip-credit related lawsuit have certainly increased over the years. Litigation under the Fair Labor Standards Act (FLSA) generally increased 270% between 2000 and 2020, with tip-credit claims undoubtedly contributing to that growth. As employers know, these lawsuits are expensive, time-consuming, and can result in unfair media characterizations (i.e., “Wage theft!”).

States are Taking Up the Fight

At the state level, we have seen an increasing number of ballot initiatives and legislative proposals that would ultimately phase out use of the tip credit.

- For instance, a new ballot initiative in the District of Columbia would increase the tipped minimum wage by a certain amount each year until it reaches the District’s regular minimum wage by 2027. The group behind this initiative announced in February that it was commencing a \$25 million campaign to advance similar initiatives in 25 other states.
- Even if they haven’t eliminated the tip credit altogether, several states such as New York, New Jersey, and Massachusetts have introduced significant increases that have resulted in swollen

labor costs for hospitality businesses.

Biden Administration Takes Aim at Tip Credit

Even those employers that have not been sued for using the (lawful) tip credit or don't operate in a state seeking to change the calculus need to be wary, however, because *all* employers who use the tip credit currently face efforts to eliminate the practice at the federal level. In the 2020 campaign, then-candidate Joe Biden voiced support for eliminating the tip credit altogether under federal law.

Perhaps recognizing that eliminating the FLSA tip credit through Congressional action is unlikely, the Biden administration has pivoted to agency action to undermine the tip credit. Last year, the U.S. Department of Labor (DOL) finalized revisions to the FLSA regulation containing the "80/20 Rule," a rule which imposes onerous time-keeping obligations on employers of tipped-employees.

As we have explained, there now are *two* distinct limitations on the amount of time that a tipped employee can spend performing "directly supporting work" (i.e., work that supports tip-producing activities but does not itself generate tips such as rolling silverware or refilling ketchup bottles). Hospitality employers already understood the difficulty in complying with the original 80/20 Rule which limited the performance of "directly supporting work" to just 20% of weekly hours performing such work. Now employers must also ensure that tipped employees do not perform such work for a continuous period exceeding 30 minutes. The inevitable consequence of this change will be more unintentional violations of the FLSA and increased litigation.

The Service Charge – An Attractive Alternative Hiding in Plain Sight?

A recent decision from the U.S. Court of Appeals for the Eleventh Circuit highlights a potential alternative for hospitality employers. While perhaps not suitable for every establishment, a service charge could be the tonic that relieves employers of their tip-credit headaches.

In *Compere v. Nusret Miami*, the upscale steakhouse restaurant in Miami owned by Nusret Gokce, also known as "Salt Bae," assessed an 18% mandatory service charge on all customers. It used those funds to meet its wage obligations for employees. The service charge payments never went directly to employees and instead were processed through the restaurant's point of sale (POS) system. The restaurant then distributed the service charge monies to employees using a point system to give each employee a pro-rata share of the total.

A former server filed a collective lawsuit alleging that this compensation plan violated the FLSA.

The critical issue was whether the restaurant's "service charge" was actually a "tip" under the FLSA. While neither phrase is defined in the FLSA, applicable regulations note a critical feature of a tip is "whether a tip is to be given, and its amount, *are matters determined solely by the customer.*"

The restaurant provided undisputed evidence that the service charge was mandatory and that customers lacked the discretion as to whether they pay the charge. For this reason, the court agreed in a March 18 decision that this was a bona fide service charge, finding the absence of customer discretion to be dispositive. The court further rejected the server's argument that the charge cannot constitute a service charge unless the employer included the charges in their gross receipts for tax purposes, an argument often made by plaintiffs in this context. The court noted that nothing in the FLSA regulations requires a service charge to be included in an employer's gross receipts for it to not be considered a tip.

Benefits of the Service Charge

But a service charge may not be feasible for every establishment. For example, some establishments may find that their customers will balk at a change from a discretionary tipping system to a mandatory service charge.

There is no doubt, however, that a service charge system unquestionably gives you more latitude under federal law when it comes to employee compensation plans.

- First, unlike tips which can only be used as wages pursuant to the tip credit for certain types of customer-facing employees, you can use service charges as wages for *any* employee.
- Second, the onerous 80/20 Rule under the tip credit regulation does not apply when no tip credit is taken and employees are paid with service charge funds. For example, a server who is paid with service charge monies can perform duties that would otherwise fall under the "directly supporting work" label – like rolling silverware – for amounts of time in excess of 20% of their working hours for the week or for continuous periods greater than 30 minutes.
- Third, unlike tips which you can never retain, you are free to retain a portion of a mandatory service charge to pay for other operating expenses.

Wait, There's More

An added benefit to the service charge model is that it can open the door to an exemption from the FLSA's overtime requirement. The FLSA's "service and retail establishment" exemption is located at [29 U.S.C. 207\(j\)](#). The "7(j)" exemption provides that certain employees are exempt from overtime (but not minimum wage) if:

- the employee's regular rate of pay is in excess of one and one-half times the minimum wage (in weeks with more than 40 hours worked); and
- if more than half of the employee's compensation for a representative period (not less than one month) represents commissions on goods or services.

In the Salt Bae case, the restaurant employer utilized this exemption through the service charge model and thus was relieved of paying its employees overtime for hours worked over 40. Although

model and thus was relieved of paying its employees overtime for hours worked over 40 hours. Although the court spent little time analyzing the issue, it implicitly acknowledged that a service charge constituted a commission for purposes of this exemption.

A 6-Six Guide to Implementing Service Charges

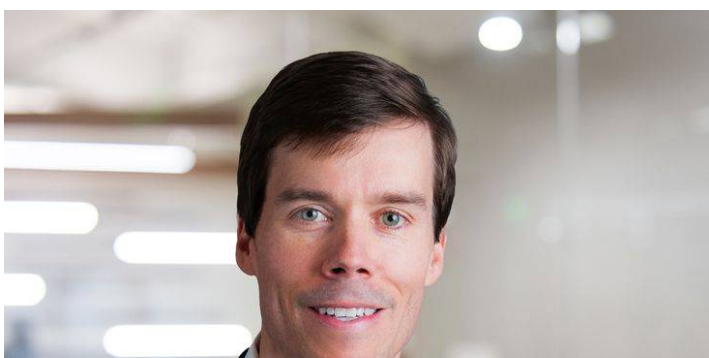
Although a service charge offers more flexibility than the tip credit, you should consider the following six precautionary steps before implementing such a policy:

- First, it is absolutely critical that payment of the service charge be **mandatory** and not up to the customer's discretion.
- Second, you should ensure that the service charge is not paid directly to employees but instead is **processed through the establishment's POS system**.
- Third, to the extent possible, you should **include service charges in your gross receipts for tax purposes**. While the Eleventh Circuit rejected this as a requirement for monies to be considered a service charge rather than a tip, district courts in other jurisdictions have reached contrary results.
- Fourth, you should confer with counsel to ensure that **all elements of the Section 7(i) exemption** are satisfied before switching to a service charge model that also relies on the exemption.
- Fifth, you should have a plan for **how to distribute tips** when a customer pays the service charge and nonetheless provides a tip as well.
- Finally, you should always be **mindful of any state or local laws** that may apply more restrictive limitations on the use of a service charge model.

Conclusion

Fisher Phillips will continue to monitor this situation and provide updates as appropriate. Make sure you are subscribed to [Fisher Phillips' Insight System](#) to get the most up-to-date information. For further information, contact your Fisher Phillips attorney, the author of this Insight, any attorney in [Wage and Hour Practice Group](#), or any member of our [Hospitality Industry Team](#).

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