ASAP™ A Littler Mendelson **Time Sensitive** Newsletter

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A federal court recently confirmed Department of Labor regulations giving hospitality industry employers the right to deduct credit card processing fees from waiters' tips, ending an attempted class action against a Chicago restaurant.

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**Hospitality Edition** | A Littler Mendelson Newsletter specifically for the Hospitality Industry

# Federal Court Affirms Legality of Deducting Credit Card Processing Fees From Servers' Tips

*By Laurent R.G. Badoux and William Hays Weissman*

A federal District Court in Illinois recently confirmed that a restaurant has the legal right to deduct the cost of credit card service charges from tips written by patrons for servers, in *Gillis v. Twenty Three E. Adams St. Corp. d/b/a Miller's Pub*, No. 04-4012, 2006 U.S. Dist. LEXIS 12994 (N. D. Ill. Mar. 6, 2006). In doing so, the court rejected a class action brought by servers who claimed to be entitled to a refund of the amount deducted. The decision brings greater clarity to the handling of credit card tips and confirms that the U.S. Department of Labor's (DOL) pro-employer position on this issue was correct.

## When Does a Tip Become a Tip? The Heart Of The Dispute

Lisa Gillis was a server at Miller's Pub and regularly received tips from customers, both in cash and on credit card slips. The owners of Miller's Pub took a tip credit against Gillis' hourly wages because she was a tipped employee, as allowed under federal and Illinois law. This arrangement was common to all servers.

Starting in October 2001, the owners of Miller's Pub began deducting a service fee from the tips left by customers on their credit cards. The service fee was identical to the "discount rate" that the restaurant was charged by the credit card company. In other words, Miller's Pub never deducted a higher amount from servers' tips than exactly what the credit company charged for processing the tips. The highest of these discount rates was 2.95%. Gillis filed suit in the United States District Court for the Northern District of Illinois complaining that the practice of deducting the service fee from her tips (and other servers' tips) was illegal. She asked the court to allow her lawsuit to proceed as a class action for all servers.

The main issue with which the court struggled was determining the point in time when tips are "received" by the server. At the core of this issue is the "tip credit" language from Section 3(m) of the FLSA, adopted in a slightly modified version under Illinois law. This language states that, for an employer to take a tip credit, "all tips received by [a tipped employee must be] retained by the employee, except that this subsection shall not be construed to prohibit the pooling of tips among [tipped employees]." The restaurant owners claimed that tips are "received" only when paid out by the restaurant. The server argued that tips are "received," and become property of the server, as soon as the customer writes the amount on the credit card receipt.

## Adopting the Department of Labor's Position

The court looked for guidance to DOL materials. The court noted that in 1977, the DOL issued a letter opinion (Opinion WH-410) stating that the Department did not question the practice of deducting from tips "an amount no greater than that charged [the employer] by the credit card company." The court further noted that the DOL has reaffirmed this position in a subsequent opinion letter (January 13, 2006), in the DOL Field Operations Handbook (Section 30d05(a)), and in its "Fact Sheet #15," entitled "Tipped Employees under the Fair Labor Standards Act."

Although the court recognized that opinion letters and other informal pronouncements by the DOL do not have the force of law, these pronouncements remain persuasive authority because the DOL is the agency charged by Congress with the administration, interpretation and enforcement of the FLSA. The court also gave greater weight to the pronouncements because the DOL's reasoning was logical, the DOL had been consistent in its interpretation for nearly 30 years and the few courts that have looked at this issue have followed the DOL's interpretation.

**Effect on the Foodservice Industry in Chicago and Throughout the Country**

The decision is only the second reported opinion of a federal court on the issue of deductions for credit card fees from servers' tips since the DOL issued its 1977 opinion on the subject. Because decisions in this area are infrequent, this latest opinion helps solidify the legality of the practice of deducting credit card processing fees from tips for federal courts throughout the United States. Although the case only serves as binding precedent in the court's own jurisdiction, it should be treated as persuasive authority by other federal courts presented with this issue.

The opinion is particularly important for the thousands of foodservice and hospitality industry operators in the Chicago area, which is located within the jurisdiction of the U.S. District Court for the Northern District of Illinois, because several lawsuits, all seeking class action status, have been filed in this area. For instance, the two attorneys representing the plaintiff in the *Miller's Pub* case filed similar lawsuits against other foodservice employers in the area, alleging, among other things, that the offset of the credit card service fees from tips was unlawful (*see, for instance, McClain v. Leona's Pizzeria, Inc., 9 W&H Cases 2d 1532 (N.D. Ill. 2004)*). Another significant lawsuit based on a similar argument was filed against Landry's Restaurants by several waiters in Chicago represented by a DePaul University law professor.

Although the decision clarifies federal law on this issue, foodservice and hospitality industry employers must continue to be vigilant of the law in the state or states in which they operate. In the *Miller's Pub* case, the parties recognized that Illinois law and federal law are virtually identical in this area. By our estimate, as many as 36 states plus the District of Columbia have adopted the language of the tipped employee provisions of Section 3(m) of the FLSA, or nearly identical language, as in the case of Illinois. Consequently, foodservice and hospitality industry employers in most states can feel far more secure about the legality of the practice of deducting processing charges from tips paid on credit cards after the *Miller's Pub* opinion.

A handful of states, however, have adopted their own definition of what constitutes a tipped employee and the employer's rights and responsibilities regarding the treatment of gratuities. The problem is that in many of these states the regulations dealing with tipped employees were implemented before the American public's current widespread use of credit cards to pay for services rendered by tipped employees. As a result, these regulations are generally silent about whether service or processing fees can be deducted from tips patrons leave on their credit cards. In other words, these regulations assume that the tip left by a patron is the same amount of money that the employer collects and passes on to the server, an assumption that is no longer true.

**Understanding the Impact of State Law on the Legality of Deducting Credit Card Service Fees from Tips**

Among the states where regulations applicable to tipped employees are different than federal law, Colorado presents a unique example of a state where authorities have dealt with the issue of deducting service fees from credit card tips. In 2004, a group of Denver-area waiters filed a complaint with the Colorado Department of Labor and Employment, complaining that the practice of deducting service fees from credit card tips by several Denver restaurants was illegal under state law. The servers were correct. Under an administrative regulation unique to Colorado (Wage Order No. 22), the term "tip" is specifically defined to include the entire amount that a patron designates as "tip" on a credit card slip, irrespective of the employer's cost for turning that tip into cash for its servers. Consequently, it is unlawful for an employer in Colorado to deduct processing fees from a server's tip and still take a tip credit for any server. Thus, the Denver restaurateurs were faced with the decision either to stop deducting processing fees from credit card tips or to stop taking a tip credit against minimum wage for their servers.

In states where the definition of what constitutes a tip (or when the tip is actually earned or received by the server) is different than under the FLSA and is not as clear as in Colorado, the question of whether deducting a processing fee from a credit card tip remains an issue. This is particularly true for states where foodservice employers could lose the right to take a tip credit against servers' wages, because the value of this credit can be as high as $3.02 for every hour worked by every member of the service staff. These states are Minnesota, New Jersey, New Mexico and North Dakota, and possibly Delaware, Hawaii, Idaho and Wisconsin.[1] In the first four states, the applicable regulations set forth different language than Section 3(m) to explain that tips belong exclusively to employees. Because this language differs so significantly from the language interpreted in the *Miller's Pub* opinion (and in DOL pronouncements), the opinion does not help clarify the potential dispute about deducting service charges from credit card tips. In the other four states, the state regulations contain no clarification about what constitutes a proper apportionment of tips, if any, or whether a deduction from tips may be appropriate. In these states, foodservice and hospitality industry employers are encouraged to check with the state affiliate of their industry association (e.g., the National Restaurant Association or the American Hotel and Lodging Association) or with the state agency charged with the enforcement of wage and hour laws about the legality of deducting processing charges from credit card tips.

**Tax Implications**

The *Miller's Pub* opinion also is important

[1] The six states where employers cannot take a tip credit are Alaska, California, Montana, Nevada, Oregon and Washington.



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for income and payroll tax withholding purposes. Tips, whether paid in cash or charged, are generally treated as taxable income subject to income and payroll tax withholding. The Internal Revenue Code and Treasury Regulations do not specifically address credit card processing fees; rather, they merely state that such tips are subject to tax "when received."

In Revenue Ruling 76-231, 1976-1 C.B. 378, the IRS discussed inclusion of charged tips in the employee's income. While not directly relevant to the purpose of the Ruling, the IRS noted that Section 3(m) of the FLSA required that charged tips be paid over to the employee. Given the acceptance of the Department of Labor's interpretation of Section 3(m) in the *Miller's Pub* opinion (and lone opinion before it), the IRS's citation to Section 3(m) suggests that the IRS also accepts that charged tips may be reduced by credit card processing fees before being "received" by employees for federal income and payroll tax purposes.

Foodservice and hospitality industry employers should review their practices to ensure that they are not withholding and remitting taxes on the full charged tip amounts if under state law they can reduce such amounts by the credit card processing fees. This can potentially reduce the tax obligations owed by both the employer and the employee.

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