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## **Guide to Restaurant Tipping Compliance with CRA**

By James Rhodes, Taxation Lawyers

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Every organization that accepts gratuities/ tips from patrons, whether it is in cash or through credit and debit cards, unwillingly becomes subject to audit by various government organizations and potential liability from those audits.

For organizations operating in Nova Scotia, that risk is from the Canada Revenue Agency as it administers the Canada Pension Plan ("CPP") and Employment Insurance Act ("EIA"), both federal statutes.

As the current Nova Scotia Labour Standards Code ("LSC") defines wage and wages to not include gratuities, this means the province does not currently legislate any rules that employers must follow in paying out gratuities to their employees. This could change if the proposed Tip and Gratuity Theft Prevention Act is enacted by the Nova Scotian parliament.

This guide was created to help you understand whether you, as an employer, have liability under the EIA and the CPP by discussing:

- The distinction between CRA's policy of direct tips versus controlled tips; and
- Thoughts and suggestions for setting up:
- Employee tip committee;
- Establishing a tip pool;
- Establishing governance rules for the employee tip committee; and
- Transferring electronic tips to the employee tip committee.

### **Direct Tips vs Controlled Tips**

Under the CPP and EIA, an employer is required to collect and remit source deductions on gratuities that are "paid" by them to employees. In order to help employers and employees define when gratuities are considered "paid", the CRA created the distinction of "direct tips" versus "controlled tips".



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## What are Controlled Tips?

If the employer is able to control how much gratuities will be paid by a patron, **or** controls the distribution of gratuities between employees, **or** it has possession of gratuities past the end of the employee's shift, **those gratuities are considered controlled tips.**

Examples of controlled tips include:

- the employer adds a mandatory service charge or mandatory gratuity percentage to a client's bill to cover tips;
- tips that are allocated to employees using a tip-sharing formula determined by the employer;
- tips that an employer includes in his business income, then expenses and redistributes to employees in the form of pay;
- tips that the employees turn over to their employer who then distributes them to the employees using a tip-sharing formula determined by the employer; and
- tips that stay in the employer's bank account after the end of the shift, with a payout the next day or later.

An employer must report the amount of controlled gratuities received by each employee on the employee's T4 slip. Employers must withhold the employee's portion of source deductions from these controlled tips and must pay their employer premiums on the controlled tips as if they were wages paid to employees.

## What are Direct Tips?

If the employer has no control over the amount of gratuities paid by patrons, and has no control over how tips are distributed between the employees, and does not have possession of the gratuities past the end of the employee's shift, those gratuities are considered direct tips.

CRA does not consider direct tips as being 'paid' for the purposes of CPP and EIA, and as such the employer is not required to withhold or pay source deductions on what is received by employees, nor is the employer required to pay an employer premium on the direct tips.



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Examples of direct tips include:

- You are part of the serving staff in a restaurant. The restaurant owner informs you that if a customer pays by credit card or debit card and includes a voluntary tip, the restaurant will return the full tip amount back to you in cash at the end of each shift.
- A customer leaves money on the table at the end of the meal and the server keeps the whole amount.
- The employees and not the employer decide how the tips are pooled or shared.
- A customer includes an amount for a tip when paying the bill by credit or debit card and the employer returns the tip amount in cash to the employee at the end of the shift.

### Summary:

**A Controlled Tip System** is one where gratuities **are considered 'paid'** by the employer to the employee. These gratuities are pensionable and insurable earnings of the employee. You are legally required to withhold source deductions from the employees on these gratuities and are required to pay an employer's premium on these gratuities.

**A Direct Tip System** is one where gratuities **are considered not 'paid'** by the employer to the employee. These gratuities are **not** pensionable and insurable earnings of the employee. You are **not** required to withhold source deductions from the employees on these gratuities and are **not** required to pay an employer's premium on these gratuities.

Thoughts to create a Direct Tip System

#### 1. Establish an Employee Committee

There are currently no rules or recommendations by the CRA on what is the acceptable set up of an employee committee. As such, in your role as the employer, and trustee of gratuities being received from patrons, you can start the formation of the employee committee to handle the sharing and distribution of tips between the employees.



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- Start by first determining who should be on the committee by considering all the roles in your organization that interact with patrons to earn the tips.
  - For instance, in a restaurant you have: the Front of House (FOH), Back of House (BOH) and management (M);
- Determine which employees in these roles would be best suited to sit on the committee and make decisions on the gratuity sharing between all employees' roles at the organization;
- Typically, the best committee members are those employees that have the most experience with the organization, have been with the organization the longest, and are the most known to employees;

### **Additional Tips:**

- There is no set number of employees that must be on the committee but try to use odd numbers to avoid deadlocks (i.e. a five-member committee might be made up of 2 FOH representatives, 2 BOH representatives, and 1 M representative);
- There is no requirement that certain employee roles must be on the committee;
- Managers can be included on the committee; however, it is best to include managers that work closely with the employees and patrons;
- Consider a reward for employees taking on the committee role, e.g. hourly pay amount for their time spent doing committee work.

## **2. Establish a Gratuity Pool**

In your role as the employer and trustee, you are allowed to establish the parameters of what employees are in the gratuity pool and to start the process of the employees making the final decision on what the sharing of the tips will be amongst themselves.

- Consider working out what the previous gratuity sharing arrangement was and determine what a comparable gratuity pool would be;
- While you as the trustee start the process, employees or their employee committee must make the final decisions on the distribution to occur.



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It is important to remember:

- The gratuity pool can be completely the same as what was used before, but it still needs to be approved by the employees or employee committee before it can be used;
- Try to establish a gratuity pool based on actual gratuities received and not on estimated gratuities using food or bar sales;
  - i.e. Avoid having a situation where say 2% of food sales are paid to BOH to be shared. Instead have the BOH get a percentage of the tip pool.

### **3. Establish the Committee's Governance Rules**

Once the employee gratuity committee is established, you need to create the governance rules for them to follow.

For example:

- The committee will meet at least once a year to determine the gratuity sharing between employees and will make the final tip distribution decision.
- The committee must put the final tip distribution agreement into writing to be signed by all committee members.
- The committee will provide the signed distribution agreement to the employer to be saved by the employer should an audit occur.
- Remember to keep the agreement for each and every year as multiple years might be audited by the CRA.
- The committee should hold elections every year to ensure that the employees vote for who will be representing them on the next year's employee committee.

### **4. Timing and Method of Gratuity Payout**

Paying out tips to the employees or employee committee after the end of the shift is too late!

- By keeping the gratuities after the end of the shift, CRA views the employer as having control and possession of the tips, and as such these tips are considered controlled tips.



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As an employer, do not collect or hold cash tips. Have cash tips collected and kept by the employees or employee committee.

- Consider the addition of a drop safe just for the employees/ employee committee to have exclusive access to.

As an employer, avoid paying out electronic gratuities by electronic means directly to employees.

- Follow CRA administrative position of paying out electronic gratuities in cash to employees or the employee committee by the end of each employee's shift; or
- Use a service such as Atlas Direct Tips [[atlasrms.com](http://atlasrms.com)] that integrates with employer POS
  - Atlas acts on behalf of employee committee and takes possession and control of electronic gratuities before they are received by the employer;
  - Atlas can also take possession and control of cash tips for employee committee;
  - Atlas acts as digital safe for employee committee before distributions are made to individual employees;
  - Distribution can be made by end of shift to individual employee bank accounts to ensure compliance with Ministry of Labour;
  - Integration with POS systems allows automatic transfer of data to perform gratuity pool calculations by the end of shift.

## 5. Practical Advice

If possible, try not to have mandatory or automatic gratuities.

- Having mandatory gratuities makes those gratuities automatically considered as controlled tips by the CRA;
- While the CRA accepts that an employee can receive both controlled tips and direct tips, there is a risk that if your restaurant has a mandatory gratuity policy and cannot clearly identify to the CRA how the amount of controlled tips versus direct tips was calculated, there is a risk that the CRA will find all gratuities received were controlled tips;
- If you have a mandatory gratuity, it is best confined or used in a clearly segregated area, say a banquet room, so that the direct tips are not combined into the same register read;



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- CRA's policy is that HST has to be charged on a mandatory gratuity but is not charged on a voluntary gratuity. Ensure that your system is able to charge HST on the mandatory gratuities otherwise you may be liable for HST not collected from patrons on these tips.

End all promises to employees for a specified share in the gratuity pool.

- The employees must always determine the final sharing of gratuities received from patrons amongst themselves.
- If you as employer agree that an employee, or group of employees, get a set share of the gratuity, you can be seen as exercising control over the distribution of gratuities and cause CRA to believe that all tips distributed are controlled tips.

Use Employment Agreements with the employees that reflect a direct tip system is in place in your organization. This will make the employees aware of the tip system in place, and such employment agreements will assist the CRA in understanding that the employees made the final decision on the gratuity sharing.

## **Conclusion & Resources**

Consider seeking a ruling from the Canada Revenue Agency. It will give you 100% certainty that your gratuity system is in compliance with EIA and CPP.

*This article has been created for informational purposes only and does not constitute the provision of legal advice. Further, as most of the discussion around what ensures a direct gratuity system has not been decided by legal cases, the views expressed in this article are only of the writer and their accuracy is not guaranteed.*

*Please consult James Rhodes at [james@taxationlawyers.ca](mailto:james@taxationlawyers.ca) if you have questions on whether the gratuities your organization pays out to employees could be subject to collection of CPP and EIA.*