



Tip and Gratuity Compliance

**A GUIDE FOR CANADIAN
RESTAURATEURS**



**Restaurants
Canada**

The voice of foodservice | La voix des services alimentaires



INTRODUCTION

In the recent court case *Ristorante a Mano v Canada* (National Revenue) (2022 FCA 151¹), the Federal Court of Appeal (FCA) found that the downtown Halifax restaurant must include the gratuities it paid to its employees when computing its Canada Pension Plan (CPP) contributions and Employment Insurance (EI) premiums for those employees. This amounted to a staggering tax bill of \$100k.

This case has served up a shocking warning to all restaurants across Canada² to ensure that their gratuity payouts to employees are in compliance with both the Canada Revenue Agency's ('CRA') view and the Court's view on when gratuities paid out by an employer to their employees are subject to CPP and EIA premiums.

In light of this decision, it is critical that restaurateurs revisit their tip out practices to employees to make sure that their gratuity structure meets both the requirements set out by the CRA and the Courts. Failure to do so could end with you being assessed with potentially three years of uncollected and unpaid CPP and EIA premiums based on the gratuities you have paid out to employees.

This guide was created to help restaurant operators with their tip compliance by discussing:

- The distinction between CRA's policy of direct tips versus controlled tips; and
- ideas on setting up a tip committee, establishing a gratuity pool and the committee's governance rules to ensure you, as a restaurant operator, stay within the legal parameters.

DIRECT 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".

¹ <https://decisions.fca-caf.gc.ca/fca-caf/decisions/en/item/521010/index.do>

² There are different rules in Quebec, where employees must declare all tips to employers, who must treat them as insurable earnings.

What are controlled tips?

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

Examples of controlled tips include:

- the employer adds a mandatory service charge to a client's bill to cover tips;
- the employer adds a mandatory 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 their 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;
- 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 gratuity received by each employee in Box 14 on the employee's T4 slip. Employers must withhold the employee's portion of source deductions on controlled tips and pay their employer a portion of source deductions.



What are direct tips?

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

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. Employees are required to report the total amount of direct tips they receive from customers, minus the amount that they pay into a tip pool, on line 104 of their tax returns.

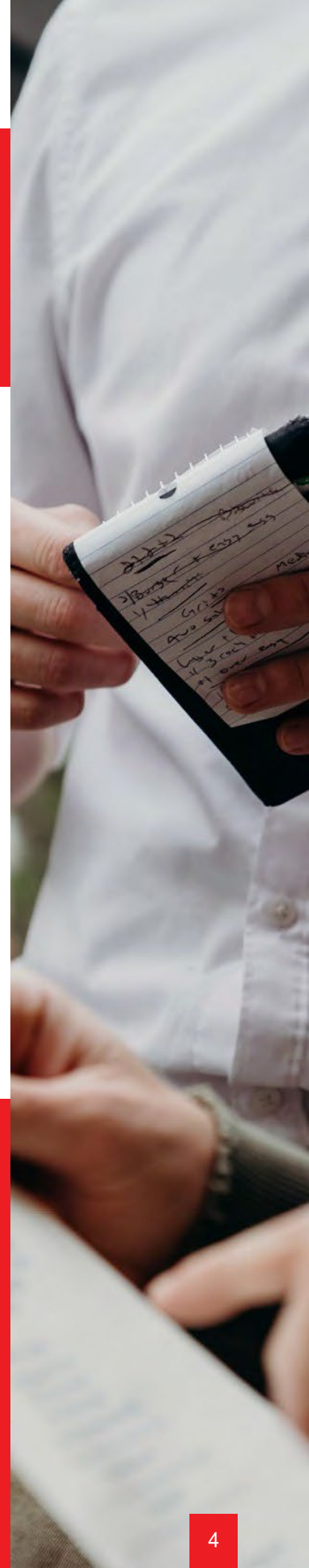
Examples of direct tips include:

- 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 and are pensionable and insurable earnings of the employee.

A Direct Tip System is one where gratuities are considered not 'paid' by the employer to the employee and are not pensionable and insurable earnings of the employee.



GUIDELINES ON CREATING A DIRECT TIP SYSTEM

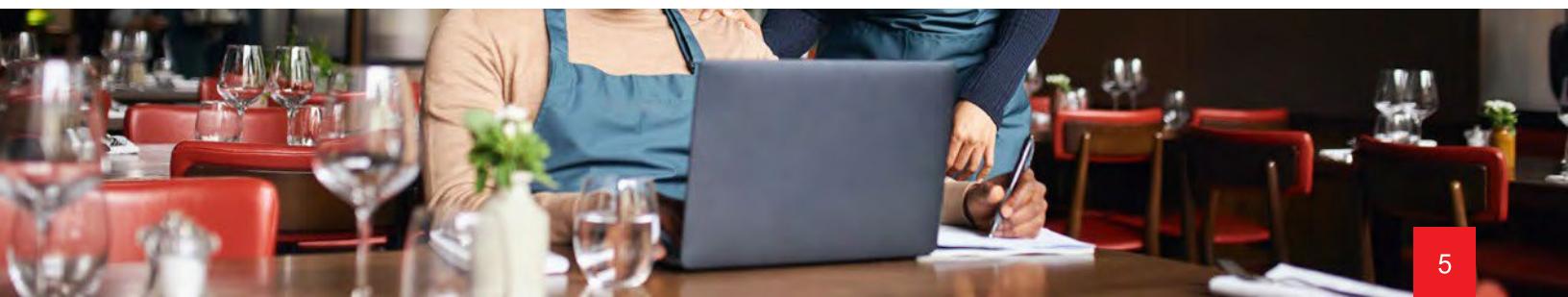
1. Establish an Employee Committee

There are currently no rules or recommendations by the CRA on what is the acceptable set up of a committee. As such, it is your role as the employer and trustee of gratuities being received from patrons to decide what is an appropriate committee.

- Start by first determining who should be on the committee by considering all the roles in the Front of House (FOH), Back of House (BOH) and management;
- Determine which employees between these three groups would be best suited to sit on the committee and make decisions on the gratuity sharing between all employees' roles at the restaurant;
- Typically the best committee members are those employees that have the most experience with the restaurant, have been with the restaurant the longest, and are the most known to employees;
- Remember to consult your provincial employment standards to determine if any requirements exist for the committee or gratuity pool.
 - For example, the Ontario Ministry of Labour states on its website that "Employers can decide if there will be a tip pool in the workplace, including who will participate in a tip pool, how it will be distributed as well as how and when the arrangement will change."

Additional Guidelines:

- There is no set number of employees that must be on the committee but try to avoid even numbers so you don't have deadlocks.
- There is no requirement that certain employee roles must be on the committee.
- Managers can be included on the committee but not if they are owners.
- Consider a reward for employees taking on the committee role, e.g. hourly pay amount for their time spent doing committee work. While they are working to distribute the employees' gratuities, they can also assist to make sure your restaurant runs smoothly when it comes to gratuities and the employees.



2. Establish a Gratuity Pool

In your role as Trustee, you are establishing the parameters of which employees are in the gratuity pool and starting the process.

- Consider working out what the previous gratuity sharing arrangement was and determine what the comparable gratuity pool will be.
- Remember, while you as the trustee start the process, employees have to approve it. Further, as the employee committee makes decisions, this gratuity sharing arrangement can change.

It is important to remember:

- The gratuity pool can be completely the same as what was used before, but it still needs to be decided upon by the employee committee.
- Try to establish a gratuity pool based on actual gratuities received and not on estimated gratuities using food or bar sales;
 - i.e. 6% of bar sales to bartenders
 - i.e. 2% of food sales to kitchen



3. Establish the Committee's Governance Rules

Once there is proper employee representation on the committee, you need to establish the governance rules for them.

- Examples of governance rules include:
 - The committee will meet at least once a year to make changes to the gratuity sharing agreement and ratify the gratuity sharing agreement for the new year.
 - The committee must put the agreement into writing to be signed by all committee members.
 - The committee will provide the signed report to the employer to be saved by the employer should an audit ever occur. Remember to keep the report from each and every year as multiple years might be audited by the CRA.

4. Practical Advice

- Having mandatory gratuities, for example an automatic tip of 15% on parties of eight or more, means that those mandatory gratuities are controlled tips.
- 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, i.e. combined tips on a single register read, 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.
- Remember that CRA's policy is that HST/GST has to be charged on a mandatory gratuity but is not charged on a voluntary gratuity. Ensure that your system is able to accommodate this if you have a mandatory gratuity.
- End all promises to employees for a specified share in the gratuity pool. Remember that the employees must determine the share of the gratuities amongst themselves. By you agreeing that an employee (i.e. manager) gets a set share of the gratuity, this will lead to the CRA finding that you as the employer have exercised control over the distribution of the gratuities and have made all tips into controlled tips.
- Use Employment Agreements with the employees that reflect a direct tip system is in place in your restaurant. 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 decision on the gratuity sharing.



5. Timing and Method of Gratuity Payout

- Remember that in *Ristorante A Mano*, the restaurant paid out the electronic tips (tips received through credit card and debit card) the next day to the employees by electronic fund transfer. The Court found that was sufficient to determine that the employer had possession of the tips, and that it “paid” that gratuity amount to the employees.
- CRA's administrative policy is that if the employer pays out all tips received, which includes electronic gratuities, in cash to the employee by the end of each employee's shift, then the employer did not have possession of the tips and the tips are not controlled tips.

CONCLUSION & RESOURCES

Tip compliance is part and parcel of the ever-changing complexity of the hospitality industry and Restaurants Canada is here to assist your business in staying ahead of the curve. This is not the first time the Tax Court has ruled on this issue, and we strongly believe that the CRA should work to clarify the law. We've made representations to the CRA regarding this issue and will continue to do so.

Restaurants Canada is also working on having payment processors create dual payment processing. Dual payment processing will allow: (1) a patron's payment for the purchase of the meal and drinks with GST/HST to go to the restaurant's merchant bank account; and (2) a patron's payment for the gratuity to go to the employee gratuity committee's merchant bank account. As the payment for the gratuity goes straight from patron to the employees, restaurants would no longer have a risk that they are seen as having "paid" gratuities to their employees, removing the risk for CPP and EIA assessments.

For further guidance on tip and gratuity compliance, please view our webinars:

[PART 1: Federal Court of Appeal Ruling:
Tips, source deductions, and how to protect yourself from liability](#)

[PART 2: Federal Court of Appeal Ruling:
Tips, source deductions, and how to protect yourself from liability](#)

For CRA guidance on tips and gratuities, please visit the [CRA's website](#).

For tax guidance, please consult James Rhodes of TaxationLawyers. [TaxationLawyers](#) is tax dispute and tax litigation boutique operating out of Kitchener, Ontario but providing services across Canada. James Rhodes is a regular speaker at events including Restaurant Canada learning seminars and provincial restaurant associations across Canada.

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 a tax lawyer if you have questions on whether the gratuities your restaurant pays out to employees could be subject to collection of CPP and EIA.

ABOUT RESTAURANTS CANADA

Restaurants Canada is a national, not-for-profit member-based trade association advancing the potential of Canada's diverse and dynamic foodservice industry through member programs, research, advocacy, resources and events.

Canada's foodservice sector is a \$95 billion industry that serves 22 million customers across the country every day. As the fourth-largest private-sector employer, Canadian foodservice directly employs 1.2 million people, and indirectly supports another 290,000+ jobs in related industries, with \$32 billion in food and beverage products purchased every year.

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