Are Tips and Gratuities Subject to EI Deductions?

The *Employment Insurance (EI) Act* and *Insurable Earnings and Collection of Premiums Regulations* set out criteria for determining if tips are subject to EI deductions:

Employment Must Be Insurable: Sec. 82 of the Act requires employers to make deductions for EI premiums from remuneration they pay to a person "in insurable employment."

Tips Must Be Insurable Earnings: Remuneration is subject to EI deductions only if it's "insurable earnings" as defined in Section 2(1) of the Regulations. Under Section 2(1)(a) insurable earnings include all amounts the employee receives "that *are paid to the person by the person's employer* in respect of that employment" (emphasis added).

Tips in Québec: Tips are also insurable earnings if employees have to declare the amounts to their employer under the tax law of their province. Only one province requires such declarations: Québec. Thus, outside Québec, whether tips are "insurable earnings" depends on who pays the money to the employee.

Example: A passenger hands a taxi driver who works for ABC Cab Co. a $20 bill for a $15 fare and tells him to keep the change. The $5 tip is clearly in respect of the driver's employment. But it isn't paid to the driver by ABC. So it's not "insurable earnings" subject to EI deductions under Section 2(1)(a). And this makes sense. After all, the payment of the $5 is a direct transaction between the passenger and the driver which is beyond the control and knowledge of ABC. Thus, it would be unreasonable to expect ABC to make EI deductions on the amount.

The 'Control' Rule

While tips are often paid by the customer directly to the employee (as in the example above), in many cases, the customer's money goes to or through the employer before it reaches the employee, e.g., where a restaurant patron who uses his credit card to pay for a meal and adds a tip for the waitress to the bill. The employer later transmits the tip amount to the waitress. The question: Is the employer's involvement enough to make the tip amount "paid to the employee by the employer" under Section 2(1)(a)?

The definitive statement comes from the Supreme Court of Canada in a 1986 ruling. A hotel operating company that hosted conventions and banquets collected tips from

customers and distributed the proceeds to the employees working those functions. The Court applied the EI regulations to determine if the hotel "paid" the tips which would make them part of the employees' insurable earnings. The Court said that the word "paid" should be interpreted broadly and could mean "mere distribution by the employer or payment of a debt owing by him." The Court then drew a distinction between tips paid by customers directly to employee and tips collected and paid by the employer. The former aren't subject to deductions; the latter are, the Court ruled.

The Court acknowledged that including both kinds of tips in insurable income would be fairer and level the playing field between employees who earn straight salary and those who depend on tips. But the Court noted that employers would unlikely to be able to keep track of each tip that an employee received directly from a customer. Consequently, the employer couldn't make proper EI deductions [*Canadian Pacific Ltd. v. Canada*].

Consequently, deductibility boils down to whether the employer has "paid" the tips to the employee. But what does "paid" really mean? What, in other words, actions or involvements in transmitting tips from customer to employee must employers take to be deemed to have paid those tips? This is an issue that courts and the CRA have struggled with for a long time.

The 4 Indiciae of 'Control'

Although each case is decided by its own facts, general principles apply to the court cases (and CRA rulings)..

Factor 1. Physical Possession of Tip Money

One of the first things a court looks at is whether the employer had physical possession of tip money. All forms of possession aren't the same. What courts look for is whether the possession represents an exercise of dominion over the money. For example, employers may let employees use company space or resources to collect or pool their tips so that the employees can later distribute the proceeds amongst themselves. This form of possession isn't likely to constitute control.

Example: Just letting employees use the employer's cash drawer to store tips till the end of the shift at which point the wait staff distributed the tips amongst themselves wasn't enough to show control over the tips and make them insurable earnings. "There is no evidence that it was the payer that paid the tips to the employees or that the payer was assessed for this portion of the remuneration," the court explained [*Guimond v. Canada (M.N.R.)].*

One thing an employer can do to indicate control over the tip money it possesses is to co-mingle the amount with its own funds. Co-mingling suggests that the employer treated the tips as its own money and is thus likely to result in a finding that control existed.

Factor 2. Involvement in Pooling and Distribution

The greater the employer's involvement in the distribution of the tips it holds for employees, the more likely it is to be found in control. But just physically providing company resources to facilitate pooling and distributing the tip money to employees isn't sufficient involvement to constitute control and payment of tips.

Example: Although it didn't actually collect, calculate and distribute tip money, a casino company went out of its way to help employees perform such functions for themselves. The casino provided protection to the employees who handled tips, a

secure space for employees to store tip money and computers to help employees calculate who should get what portion of the tip money collected. The casino also signed off on the tip records the employees created to make sure employee tips weren't co-mingled with casino funds. CRA claimed this involvement constituted control and made tip money subject to EI deductions. But the court disagreed. The casino signed off on employee records not to exercise control but to ensure that tips weren't co-mingled with casino funds, the court held [*Lake City Casinos Ltd. v. Canada (M.N.R.)*] .

By contrast, control is more likely to be present if an employer collects tips from customers, sticks the proceeds into a common pool, calculates how much money each employee gets and distributes the money to each employee. An even clearer sign of control is when the employer incorporates tip collection and distribution functions into its payroll processes [*S & F Philip Holdings Ltd. v. Canada (M.N.R.)*].

Factor 3. Keeping Records of Tips

Remember the rationale for the control rule is that it's unfair to require employers to make deductions over amounts they can't track. So when employers do make a record of or otherwise monitor the amount of tips collected and distributed, they enhance the likelihood that control will be found.

Example: An employer operating a resort hotel created a record of tips and how they were distributed among employees. It also had an accountant verify tip amounts from credit card receipts and was involved in distributing the tips to employees. The court concluded that because the tip amounts were known to the employer and included in T4 slips issued to employees, the tips were insurable earnings. As in Canadian Pacific, that court drew a distinction between tips known to the employer and those that went to the employee directly and which the employer wouldn't be able to track [*S & F Philip Holdings Ltd. v. Canada (M.N.R.)*].

Factor 4. Employer Discretion over Tip Amounts

Employers are more likely to be considered in control when they have a say over how much tip money each employee receives. One way for employers to exercise this discretion is to make distributions from a pool of tip money according to its, the employer's, own criteria. Another is to reserve the power to dock tip money from employees.

Example: A court held that tips were insurable earnings when an employer could deprive a bar's night manager of a share in the wait staff's tips equal to 1% of the wait staff's sales. The employer also recorded the sales to determine the tip, collected the amount for staff tips and paid it to the night manager [*Peron v. Canada (M.N.R.)*].

According to a CRA external interpretation letter, still another way for an employer to exercise control is to set the tip as part of the total contract amount due from the customer or otherwise include it in the price for services. Thus, for example, control is likely to be found when a restaurant automatically adds a 15% service gratuity to each bill.

Conclusion

The more you get involved in passing tips from your customers to your employees, the greater the likelihood that you have control. Although there's no bright-line test for control, you should ask yourself the following questions:

- Do you physically collect tip money?

- Do you co-mingle tip funds with your own money?
- Do you keep records on tip amounts collected and distributed?
- Do you exercise discretion over who gets what amount of tip funds collected?

The more of these questions that you answer “yes,” the more likely it is that you have the kind of control necessary to trigger the obligation to make EI deductions.