Taxing Tips in an Electronic-Payments World

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Re-imagining Tax for the 21st Century: Inspired by the Scholarship of Tim Edgar
Saturday,13:15 - 14:30. Session 7: Tax, Technology and Digital Economy (1)

1. Introduction

Governments in Canada and Quebec have had a longstanding goal of minimizing the size of the underground economy; the desire to keep tax rates on marijuana sales low following the October 17 legalization of most marijuana use is just the most recent evidence of that. Given this trend in public policy, the current system of taxation of tips and gratuities – making them taxable according to the law but largely untaxed in practice -- seems increasingly anachronistic. How can a government claim to be serious about the underground economy if it ignores an obvious area of tax evasion that is all around us? As Nitikman (2017) writes: "[T]ax evasion…is very much in the eye of the beholder... I think they [the public, the press and the politicians] would say that it means using technical loopholes or clever strategies to avoid paying tax that 'should' (in some moralistic way) be paid, even while they themselves do the same thing on a smaller scale."[1]

Until now, the only alternative to the current system of taxation of tips has been to withhold and report on tax slips on the basis that reported tips must be at least a fixed percentage of the server's sales (8% in Quebec and for some restaurants in the US). Withholding and third-party reporting for electronically-paid tips alone was not taken seriously as a solution because it ignored the large amount of cash tips; filling that gap with an imputation for cash trips was not regarded as sufficiently accurate. Hence, public policy has been at an impasse. But now, with cash payments on the wane with modern electronic-payments technology (debit cards, credit cards, and digital wallets such as Apple Pay and Android Pay), withholding and reporting just the electronically-paid tips seems like a viable solution. This argument is presented in detail below. Less-viable alternatives such as public education and regulatory initiatives are also explored.

2. Current Canadian Law

Subsection 5(1) of the (federal) Income Tax Act states that a taxpayer's income from office or employment is the salary, wage and other remuneration – "including gratuities" – received by the taxpayer in the year. Thus, the law is clear – tips are taxable.

Withholding of tax at source, and reporting of employment income on T4 slips, is a different story. Subsection 153(1)(a) requires that the payer of "salary, wages or other remuneration" (with some

[1] P. 688

exclusions for non-residents) make withholdings of estimated tax on the employee's paycheque. Whether tips are included under this regime has never been settled in court. The Canada Revenue Agency (CRA) currently distinguishes between direct tips and controlled tips, with only the latter being subject to withholding and T4 reporting. Controlled tips are also subject to Canada Pension Plan contributions and Employment Insurance premiums, while direct tips are not. The distinction between the two types of tips is set out in CRA guidance[2, 3], and in particular that guidance in relation to EI premiums and CPP contributions.[4] The CRA regards direct tips as those which are collected directly by employees, (including pooled tips as long as the employer does not mandate the method). Tips originally paid by a card, debit or credit, and paid directly in cash to the employee by the employer appear to be counted at direct tips. Controlled tips take the form of mandatory service charges (a common requirement in restaurants for larger groups of patrons); payments made directly to employees such as by direct deposit; and any tips where the employer directs how the tips will be paid.

Conversations with individuals working at restaurants suggest that enforcement of the distinction between controlled tips and direct tips may be loose. For example, in one case, management organized tip pooling but tips were not still not subject to withholding or included on their T4 (Wright, 2012). Restaurants are said to be confused about the distinction.[5] Of course, an employer classifying a tip as a direct tip will have additional costs of income tax administration and a direct cashflow cost from payroll taxes.

3. Compliance with Current Law

The inclusion of tips as taxable income has been dismal in the absence of withholding of tax and source and reporting of income on tax slips. In the early 1980s, when the United States had similar tax rules around tips as Canada currently does federally, only 16% of estimated tips in that country were reported (Macnaughton and Veall, 2001). More recent Canadian studies find similar results. In 2012 the CRA conducted an audit of 145 servers at four St. Cathartines, Ontario restaurants and not even one of them had fully reported their tips. They noted that generally only five percent to 10% of the server's wage was reported as tips when in fact, based on the results of the audit, tips were estimated to be up to double their wages. Given the estimated unreported tips for the 145 servers was $1.7 million and that there are 1.3 million employees in the accommodation and food services industry in 2017 the magnitude of this problem is quite large. To be fair not all those 1.3 million employees receive tips and fewer work in restaurants, but a large number do.

To look at this another way Statistics Canada estimated in 2013 that the 11.7% of the underground economy of $45.6 billion, about $5.3 billion, relates to accommodation and food services with

[2] CRA document no. 2006-0202891E5, February 16, 2007

[3] CRA document no. 2007-0232621E5, February 29, 2008

[4] Canada Revenue Agency. (2012, March 16). Tips and gratuities. Retrieved from https://www.canada.ca/en/revenue-agency/services/tax/canada-pension-plan-cpp-employment-insurance-ei-rulings/cpp-ei-explained/tips-gratuities.html

[5] O'Kane, J. (2018, May 16). The taxation of tips is a murky area for restaurant staff and owners. Retrieved from https://www.theglobeandmail.com/report-on-business/small-business/sb-growth/a-tip-for-restaurants-keep-your-hands-off-the-gratuities/article30081176/

tipping being part of that.[6] Yet this amount could even be on the low side as in 2008 Statistics Canada thought only $750 million[7] was related to undeclared tips. CRA investigations found that number to be $2.7 billion to $6 billion in that year, for servers only. As far as lost tax revenue that is harder to estimate as it will depend on personal marginal tax rates of each server and any unused non-refundable credits. Despite being hard to estimate, a 2005 Quebec study found that the lost tax revenue in 2002 associated with restaurants was $303 million.[8]

In an interview-based study of 52 restaurant managers and 47 restaurant servers, the majority of whom were in Ontario, McAdams and von Massow (2016) found that servers averaged $18 per hour in tips earned. The authors report a minimum wage at the time of their study of 8.60 per hour, and so they conclude that $18 of the $26 average employment earnings is from tips.[9]

The problem this creates is that a segment of the population, those earning tips, is not reporting what can amount to a large portion of their taxable income. The CRA found that restaurant servers make 100 to 200% of their wage and salary income in tips. Thus, as one might expect given the size of tips, 200 servers in Prince Edward Island reassessed for their 2014 and 2015 tax returns were caught off-guard and had trouble paying the tax bill[10, 11].

Nevertheless, it is clearly both expensive and difficult to enforce the reporting of tip income under the current rules. While the news reports on a few hundred servers getting caught per year, there are clearly many more that are not investigated, presumably due to the cost and the small tax bill per individual.[12] McAdams and von Massow report regarding restaurant managers: "While it has surprisingly not been an issue in Canada to date, managers are aware of the potential for tax liability issues around tips and tip pools. This is a source on ongoing concern for many managers."[13]

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6 Statistics Canada. (2016, June 20). The underground economy in Canada, 2013. Retrieved from https://www150.statcan.gc.ca/n1/daily-quotidien/160620/dq160620b-eng.htm

7 Tedds, L. (2018, May 01). Tipping point: Ottawa loses billions in undeclared income. Retrieved from https://www.theglobeandmail.com/report-on-business/economy/economy-lab/tipping-point-ottawa-loses-billions-in-undeclared-income/article4418504/

8 Finances Quebec. (2005, April 22). Tax Exasion in Quebec. Retrieved from http://www.finances.gouv.qc.ca/documents/EEFB/en/eefb_vol1_no1a.pdf

9 The minimum wage in Ontario for liquor servers has been $12.20 per hour since January 1, 2018: "Minimum Wage". https://www.ontario.ca/document/your-guide-employment-standards-act-0/minimum-wage

10 O'Kane, J. (2018, February 19). CRA cracks down on undeclared tips for restaurant and bar staff. Retrieved from https://www.theglobeandmail.com/report-on-business/small-business/talent/cra-cracks-down-on-undeclared-tips-for-restaurant-and-bar-staff/article38025478/

11 Putter, K. (2017, January 26). CRA crackdowns incentive for service workers to declare tips on taxes. Retrieved from https://ca.finance.yahoo.com/news/cra-crackdowns-incentive-for-service-workers-to-declare-tips-on-taxes-202545812.html

12 Oved, M. C. (2016, June 26). CRA has double standard for tax cheats. Retrieved from https://www.thestar.com/news/world/2016/06/25/cra-has-double-standard-for-tax-cheats.html

13 Page 11.

4. Policy Alternatives Currently In Use

In looking to alternative ways to regulate the compliance with tips it is first helpful to look to the example set by other countries. In the case of tips this becomes more difficult as culturally tips are much less prevalent outside of Canada and the United States.

Increased Education

It has been suggested that increased education as to the requirements to report tips in income, the fines for not doing so and well as publicising when servers are caught for not reporting taxes will help increase compliance. Government can also point out that employees will benefit from the increased benefits under the Canada Pension Plan and Employment Insurance which are produced from increased reporting. While all the above are excellent, they will not solve the non-reporting problem alone. Personal conversations with individuals who are servers, while admittedly a small and non-random sample, suggest they are all fully aware of the requirement to report their tips on their tax return. However, they choose not to do so for what seems to be two reasons. First, they do not want to pay the tax on that tip amount thinking they will not get caught and second, they do not want the hassle of, or simply forget to, record their tips on their own time. Education can also include the highlighting the benefits of reporting increased income such as greater CPP for retirement and higher RRSP contribution room, however, these are not as financial beneficial as not paying any tax on the income in the first place. Education, of both the benefits of and disadvantages of not reporting income, will not be enough to fix the tax evasion problem with restaurant servers.

Minimum Tips a Percentage of Sales

This is a method used both in Quebec,[14] and in the United States for large employers. A minimum calculated amount must be reported. When the employee reports an amount of tips below this amount, the employer will adjust the reported amount upwards to the threshold. In both Quebec and the United States this threshold amount is 8% of sales applicable to the employee but can be reduced if the company supports that the actual amount of tips is below the default threshold. [14]

The reason why the government has chosen such a low percentage of sales (relative to actual tipping percentages of customers observed in practice) is presumably that the government cannot take the risk that some servers would be taxed on more tips than they have actually earned. The public outcry, given that servers are perceived as low-income workers would be too great.

Clearly, the major problem with the fixed-percentage method is that it is likely to result in an under-estimate of the proper taxable amount.

5. Regulatory Solutions

Two methods which have been suggested, but are believed to be not in use anywhere, involve the government regulating tips.

[14] Revenu Québec. (n.d.). Tip-Allocation Mechanism (Also Known as the 8% Rule). Retrieved June 10, 2018, from https://www.revenuquebec.ca/en/citizens/your-situation/tips/employees-who-receive-tips/tip-allocation-mechanism-also-known-as-the-8-rule/

Mandate Tip Rate, Discourage Additional Tips

In this method all patrons are charged the tip or service charge as part of their bill at a fixed percentage. This charge could be set by the restaurant or mandated by the government. Because of the service charge it would be less likely an individual would add an additional tip to the bill, effectively ending the practice of tipping in restaurants. To further discourage additional tips the tipping function on credit card terminals could be mandated to be removed but this could backfire and result in a shift to harder to track cash tips. This is similar to how some restaurants currently assess a charge on large groups. The employer would than include this income as part of the employee's wages which includes withholding and reporting requirements. Under the current CPP and EI rules the employer would also assess these payroll taxes, which begs the question if that rule would need modification. Interestingly this policy would mirror those in Europe where this is done primarily culturally.

Administratively this would be easy to enforce and could be co-enforced with wage income regulations. Any additional tips would still need to be self-reported, but it would be expected they would be extremely minimal, so the impact would not be material.

The problems with this approach are not so much with the standard questions of tax fairness and general policy objectives but with bureaucratic overreach and public acceptance. The tipping culture in Canada is strong and many individuals would see mandating a service charge on a private business an overreach over what a government should do. Finally, there is question to the ability for the federal government to impose these such rules due to the division of power under the Constitution Act, 1867. Subsection 91(3) gives the federal government broad powers of taxation but subsection 92(13) assigns provincial government power over property which the setting of prices likely falls. Because of these issues it likely impractical to use such a system.

Outright Ban on Tipping

Along the same lines of the mandatory tipping option is the option to have an outright legal ban on tips. Even if this was effective in stopping tips, and thereby unreported tip income, it would be an even stronger case of bureaucratic overreach than the mandatory tipping option. Further it would be hard to enforce and likely politically disastrous as fining patron or servers for tipping would be hard to justify to the public. It would be even harder to educate tourists, particularly American tourists who are used to tipping at home, on the matter. Hence, an outright legal ban will not be considered further.

6. Taxing Electronically-Paid Tips, with Cash Tips Taxed by Imputation

Tips that are paid electronically as part of the payment of the restaurant bill must pass through the restaurant's accounting system. Thus, provided the server for any particular table is identified in the accounting system, the amount of such tips attributable to each server could be identified and made subject to withholding and T4 reporting. Essentially, the end goal of the proposal is to treat all restaurant tips in the way that controlled tips are treated under current CRA policy.

Many restaurants employees give, or are forced to give, a portion of their tips to staff who do not receive tips. Under the proposed changes there will be no changes to this other than that these employees will also see the amount of the tips appear on their T4 slips. As these tips are generally paid directly out of a tip pool, management should be able to track the amounts being redistributed. Obviously, any amount a server adds to the tip pool will be removed from their taxable tip income.

Restaurants would have the choice over what controls they want to set up to ensure the reported amount is correct. Specifically, electronically-paid tips will be easily tracked as terminal IDs can be assigned to each server which will print out a report for management, or digitally record it into the company's accounting and payroll software, summarizing the total tips. This already needs to be done by management for them to convert an employee's credit card tips into cash for them. So, the focus of the controls needs to be over cash as cash tips are rarely seen by management under the current system. Even in current tip pools the amount contributed is based on sales usually, presumably due to this very problem of tracking cash tips. Some examples of controls are:

1) Implement by choice the mandated included tips policy. This would have the benefits described earlier in this essay without the political issues discussed.
2) Require all cash tips to be handed over to management for tracking, just as cash from sales would be, or required the amount be logged in some fashion which will ensure compliance. This would need to be accompanied by a system of controls to ensure compliance but as it is administered by the employer the chance of getting caught would be higher than by the CRA thereby discouraging a violation of the rules. Additionally, getting caught for non-compliance could result in termination in addition to termination increasing the incentive to report.
3) Refuse to accept cash. While this is not yet common in Canada there are stores that are starting to only accept cards. While someone could still leave a cash tip it would be much less likely as they already must enter credit card information.

It would be reasonable to allow the business, if they had reasonable controls in place to attempt to track cash tips, such as those suggested above, to be not liable for cash tips which employees fail to disclose. In addition to relying on the company controls, large fines for the server could be imposed for failing to report cash tips to their employer. In practice though, these would be a rarely enforced due to the difficulty of determining the cash tips unless a large a portion of the tips in a given restaurant are cash based, in a cash only establishment for example.

This system also eliminates the need for an appeals system that the minimum assumed tip system requires. As actual tips are always being reported so there is no minimum threshold to compare against. Reporting low trip amounts on employ T4s may cause the CRA to take a closer look but once they establish the business is low tipping, say because of a publicly stated "no tipping" policy then they could accept the business' controls are adequate and move on.

The major downside to this proposal is that there would be an increased burden on businesses due to the increased reporting and control requirements.

So, why has this method never been used in any country, to the authors' knowledge? The problem with this approach is how to deal with tips paid in cash, which typically occur when the restaurant bill is also paid in cash.

The Imputation Problem for Cash Tips

One way to solve this problem is to estimate the amount of cash tips using the McQuatters formula. The McQuatters formula uses actual tips generated on credit/debit card sales and extrapolates them with adjustments over all sales by the employee to come up with an estimate of the amount of cash tips received by that employee. The McQuatters formula can allow for differences between the tipping rate on electronic payments and the tipping rate on cash payments; the latter is often assumed to be 2 percentage points lower. This method has so far only been used in an audit context, (e.g., Tampopo Garden Ltd. v. M.N.R., 2011 TCC 324) to determine the amount of cash tips when it has already been established that the server has failed to report tips.

The question is whether the McQuatters formula could be used to determine the amount that must be used for tax purposes.

A major problem is that if a restaurant has a large percentage of its tips in cash, there is a likelihood of substantial error in the use of the McQuatters formula. For example, if a restaurant has 10% of its sales by electronic payments, the tipping rate on those electronic payments will be applied to the other 90% of sales. If the tipping rate on cash payments is significantly different from the tipping rate on electronic payments, large errors can occur. A simple 2% adjustment, as suggested above, may not be adequate to deal with this problem. Either over-taxing or under-taxing may be the result.

A second problem with using the McQuatters formula to determine taxable amounts was pointed out by Macnaughton and Veall (2000). Consider the way the formula works: an additional credit card tip will imply an additional taxable amount from cash tips. In restaurants with a large value proportion of sales in cash it was shown that this could result in a marginal tax rate on the additional credit card tip of over 100%. Further, most servers are low income individuals[10] and they are now paying a potential marginal tax rate on a credit card tip of greater than the top marginal rate. Mitigating the impact is this is offset by the fact they pay no marginal tax on one additional cash tip.

7. Trends in Payment Methods

There are two important sources of data on Canadians' payment methods: the Bank of Canada's surveys of consumers; and Payments Canada's data obtained from Interac and financial institutions. Neither is perfectly suited to our purpose of understanding payments in restaurants. The Bank of Canada data is better in that it focuses on consumers, but it is based on consumers' reports of the behaviour rather than actual transactions. Payments Canada data covers actual transactions, but it includes non-consumer payments in most of its statistics. A similar trend away from cash appears in both datasets, but the proportion of cash use is quite different.

Bank of Canada's Methods-of-Payment (MOP) surveys of consumers were conducted in 2009, 2013 and 2017. The 2017 survey results were released in December 2018. Results are reported in terms of both transaction value and transaction volume. Value would seem to be the best issue for this purpose, since we are trying to measure the percentage of total tips that are electronically paid. The particular choice of which electronic payment used is not important, since all electronic payments would be tracked through the restaurants' accounting systems.

The MOP results (Henry, Huynh and Welte, 2018) are that cash as a percentage of total transaction value was 23% in 2009, 23% in 2013, and 15% in 2017. In terms of volume, the cash percentage was much higher: 54% in 2009, 44% in 2013, and 33% in 2017.[15] Note the sharp decline in just four years, from 2013 to 2017: one third in the case of value, and one-fourth in terms of volume.

For this purpose, one important qualification to this trend of declining use of cash is shown by the Bank of Canada's breakdown by type of good or service. Specifically, in 2017 cash's proportion for "entertainment/meals" is higher than that for transactions in general: 30% vs. 15% in value,[16] and 41% vs. 33 in volume.[17] On the other hand, the mean purchase amount for a cash transaction in 2017 was $20, versus $44 for debit cards and $62 for credit cards,[18] so that factor would go the other way – suggesting that purchases in restaurants might be a lower percentage of their value being in cash.

Payments Canada (2018), since it covers business-to-business payments as well as consumer payments, shows a much lower use of transaction value in cash: 1.2% in 2017 (vs. Bank of Canada's 15%). The 1.2% is a sharp decline from 1.9% in 2012.[19] Cash transactions considered on their own, rather than as a percentage of total payments, declined in value by 21% from 2012 to 2017, and by 2% from 2016 to 2017.[20]

Payments Canada also reports a small amount of data on payments made directly to merchants or payees (point of sale (POS) transactions), as opposed to remote transactions (those enabled through third parties, such as banks, PayPal). POS transactions are perhaps closer to the Bank of Canada's consumer survey data. Cash represented 12% of POS transaction value in 2017, which is close to the Bank of Canada's 15% figure reported above.[21]

Payments Canada reports that the movement away from cash continues, but has slowed: the value of transactions conducted in cash declined at a 5% rate prior to 2016, but in 2016 and 2017 it declined by 2% relative to the respective previous years.

Payments Canada also reported some survey data. The use of cash was greater in the Prairie Provinces and much less in BC. Heavy cash users – those using cash for more than 50% of their purchases – tended to be younger (not older, as one might expect), lower income and rural. For lower-value food and coffee purchases, consumers are using about 20% less cash than in 2012. [22]

8. Third-Party Reporting Only For Electronically-Paid Tips

[15] Page ii.
[16] Page 45, Table 18.
[17] Page 44, Table 17.
[18] Page 43, Table 14. Median purchase amounts in 2017 were lower for all payment methods, but otherwise show a similar pattern: $10 for cash, $25 for debit cards, and $35 for credit cards (p. 8).
[19] P. 12.
[20] P. iii. The decline in volume terms was 19% from 2012 and 2% from 2016.
[21] P. 14.
[22] Page 14.

As suggested above, there appears to be no answer (beyond relying on self-reporting) to the problem of taxing cash tips: embedding the McQuatters formula in tax law as the general system for taxing cash tips involves an unacceptable amount of error and, in particular, the likelihood that some people will be over-taxed.

An alternative approach is to simply continue with the current self-reporting approach to cash tips, and apply withholding and T4 reporting only to electronically-paid tips. As cash use declines, a higher and higher proportion of total tips will become included in the third-party reporting.

One problem is that this may cause servers to encourage customers to tip in cash, defeating the purpose of the system.

Another issue is whether servers could set up their own payment systems for collecting tips. The restaurant patron would then pay the restaurant for the meal, and then electronically pay the server directly his or her tip.

The impact of these proposed changes will be widespread. With hundreds of thousands of Canadian workers and many businesses impacted, there will undoubtedly be issues that have not yet been considered. A gradual and phased-in implementation is recommended. At first only large business, say with over 50 full-time-equivalent employees could be affected, on the basis that larger business will be better able to absorb the increased compliance costs. Then once the government feels the system is functioning it can be expanded to all restaurants. Eventually it could even be expanded to other businesses with tip-compensated employees; coffee shops, barbers, etc. Until such time as the new reporting rules take applied to a particular business those employees would continue to be subject to the now existing rules.

9. Conclusion

Given the alternatives, the preferred solution make be to make all electronically-paid tips "controlled tips" in the CRA terminology, i.e., subject to withholding and third-party reporting. The end goal is to level the field between those who can get away with evading taxes through receiving income through tips and those who cannot and to remove the financial disadvantage of being honest when reporting tip income.

The proposed system is not known to be used anywhere else in the world but there are very few places in the world with the culture attitude towards tipping that exists in Canada, so this is not unexpected.

Given this lack of a precedent for this system in any other country, a slow implementation is also recommended with sustainable consultation to identify problems early and keep people informed.

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