Low Incomes Tax Reform Group.
A voice for the unrepresented.

Department for Business and Trade (DBT)
Distributing tips fairly: draft statutory code of practice
Response from the Low Incomes Tax Reform Group (LITRG)

1 Executive Summary

1.1 We welcome the opportunity to comment on the draft statutory code of practice which supports measures in the Employment (Allocation of Tips) Act 2023[1].

1.2 The aim of this legislation is to ensure that 100% of tips, gratuities and service charges paid by customers are allocated to workers in a fair and transparent way. The new rules will likely mean some employers will pay service charges over to workers for the first time (as opposed to keeping them) and/or that employers will adopt different practices, such as removing service charges so that they do not have to handle tips. It is therefore likely that more workers will start to receive tips and/or receive them in a larger amount – and potentially in different ways.

1.3 Tips are taxable income on workers and the way that tax is dealt with can be complex depending on how the tip reaches the worker's pocket. There are also knock-on consequences for any welfare benefits they are on.

1.4 For example, if an employer is going to start passing on service charges to workers for the first time, then they need to understand that this needs to be done under the Pay As You Earn (PAYE) system. This means that income tax and National Insurance (NIC) liabilities on the tips should be deducted before workers receive them. This also means that the workers should not have to do anything else to notify HMRC or DWP about the tips for tax or universal credit purposes.

1.5 To the extent an employer does not operate PAYE either at all or correctly, there can be ramifications for both them and workers. Therefore, we urge the government to include in the code

[1] https://www.legislation.gov.uk/ukpga/2023/13/enacted

of practice or the supporting guidance some basic information for employers, or even simply a signpost to information[2], to help them understand what their PAYE obligations are.

1.6 Employers should be strongly encouraged to signpost workers to some improved official government guidance on how tips are taxed. This should therefore also be incorporated in the code of practice /supporting guidance.

1.7 Finally, we think more could be done to incentivise and increase the prevalence of well-managed tronc systems – a way of pooling and distributing tips without any employer control. We believe this could further help improve many workers' positions, not least because, if operated correctly, the tips will not attract a Class 1 NIC liability – offering a saving to the worker.

2 About Us

2.1 The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998, LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low-income workers, pensioners, migrants, students, disabled people and carers.

2.2 LITRG works extensively with HM Revenue & Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.

2.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3 Introduction

3.1 Tips are an important source of income for many low-paid workers, particularly in the hospitality sector. We therefore welcome the new rules, which should ensure employers do not retain tips meant for their employees and look set to boost the financial positions of many workers[3].

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[2] This would probably be booklet E24: https://www.gov.uk/government/publications/e24-tips-gratuities-service-charges-and-troncs

[3] Figures can be found here: https://www.gov.uk/government/news/millions-to-take-home-more-cash-as-new-law-on-tipping-passes

3.2 We are not responding as employers or workers so have not answered the vast majority of the individual questions in the consultation. The focus of our response relates mainly to providing some general comments in the area of tax on tips as this is within our interest and expertise. As ultimately our main request is for guidance, our comments could feed into question 34.

4 Substantive comments

4.1 The taxation of tips in the UK can be complex as the treatment varies depending on how the tips are paid. If the employee receives and keeps their own tips, they are responsible for declaring those tips as employment income. However, if the tips are either received by the employer (as is often the case with restaurants applying a service charge) or pooled under a system called a 'tronc', then PAYE tax should be operated on the tips when the employer or troncmaster distributes them to the individual employees.

4.2 Similarly, the Class 1 NIC treatment of tips and gratuities depends on the actual treatment of the tips. Class 1 NICs only apply where the employer receives and/or pools the tips before allocating them to the employees and operating PAYE. In such a case it is the employer who is the secondary contributor and liable for secondary contributions.

4.3 We include, at Appendix 1, more detail around the rules, in a news article that we put together for workers.

4.4 The new rules will likely mean some employers will pay tips that fall within the legislation[4] over to workers for the first time (as opposed to potentially keeping them). As such both employers and workers need to understand that this must be done under the PAYE system and means that tax and NIC liabilities on the tips should be deducted before workers receive them. As the tips will be included in the employer's Real Time Information return, this also means that workers should not have to do anything else to notify DWP about the tips for universal credit purposes.

4.5 If the employer does not do this or does not do this correctly, in the majority of cases, HMRC should recover the tax from the employer by using a Regulation 80 determination[5]. The employer has a right to appeal against this determination if they think it is incorrect, but if no appeal is lodged or allowed, the determination becomes final and conclusive within 30 days.

4.6 If HMRC are satisfied that the employer took reasonable care to comply with the PAYE Regulations and any underpayment of tax arose due to an error made in good faith, HMRC will instead seek recovery of the tax from the employee[6]. HMRC will also seek collection of the tax from the employee

[4] Under the legislation, qualifying tips are 'employer received tips' or 'worker received tips' where an employer 'exercises control' (where the employee is required to pool cash for example). The Act does not cover cash tips left directly to a worker.

[5] SI 2003/2682, Reg 80

[6] SI 2003/2682, Reg 72

if they have reason to believe that the employee accepted their earnings in the full knowledge that the employer had under-deducted tax.

4.7 So to the extent tips are not paid over to workers properly, there can be ramifications for both the employer and the worker with regards to tax. In addition, any universal credit award for the worker may be wrong.

4.8 While the aim of the Act is laudable, from a practical perspective, there are going to be increased administrative obligations on employers. There may also be costs, especially if they cannot make deductions for such items as credit cards fees and commissions, bank charges, payroll costs or any other administration[7].

4.9 To avoid incurring costs and/or to discharge some of their obligations (for example the obligation to ensure tips are allocated fairly or the obligation to operate PAYE), from a practical perspective it seems to us that employers may:

- Change their approach by adopting a no service charge policy, meaning workers are more likely to receive tips directly (for example informal cash tips left on the table), or
- Use a tronc system to allocate the tips independently of the employer[8].

4.10 To this end, we think that it is vital for employers to signpost workers to some good and clear official government guidance on how their tips are taxed (however their tips are paid). Therefore, this instruction to employers should be incorporated in the code of practice or supporting guidance. Current GOV.UK guidance[9] would need to be improved if it is to be used for this purpose. For example, it needs to cover what to do if the tax deducted at source results in the worker overpaying tax and being eligible for a tax refund. It should also cover cash tips in more detail – how to record them, what to do about benefits etc[10] - in reality, we think many cash tips currently may go unreported and untaxed.

4.11 We also think more could be done to incentivise and increase the prevalence of well-managed tronc systems. We believe this could help improve many workers' positions, not least because if operated correctly, such tips will not attract a Class 1 NIC liability – offering a saving to the worker.

[7] The legislation refers to the 'total amount' of the qualifying tips, gratuities and service charges left by the customer being paid over to the worker, so this seems to rule out any such deductions.

[8] A tronc system is the common method used to distribute tips. The tips given by customers are pooled into a collective fund, known as the tronc, and a troncmaster is then appointed to determine how the tronc monies will be distributed amongst staff. The troncmaster also has responsibility for ensuring that the tronc is subject to PAYE deductions and may be held responsible for any failure to do so. The troncmaster can be either an internal member of staff who agrees to take on the role or can be an externally appointed professional company or individual.

[9] https://www.gov.uk/tips-at-work/tips-and-tax

[10] Potentially drawing on some of the detail in the article in Appendix 1

4.12 Currently the requirements for setting up and running a tronc correctly are complicated. So complicated in fact that a whole industry has sprung up offering troncmaster services – which usually come with fees. At the moment, employers may deduct administrative fees from tips, in order to cover the costs of appointing an external troncmaster. However, under the provisions of the Act, as stated above in para 4.8, it seems this will be expressly prohibited. Similarly, even if an internal member of staff were elected to act as the troncmaster in an attempt to minimise these costs, this is again potentially problematic, due to the complexities and barriers that we explain in detail in our submission to DBT's predecessor department from 2016[11].

4.13 We think that a tronc should be something that staff members can set up and run themselves without undue burden. In order to achieve this, DBT and HMRC need to work together to ease the process for troncmasters – this may be by simplifying the rules and/or by providing much clearer guidance.

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[11] https://www.litrg.org.uk/submissions/tips-gratuities-cover-and-service-charges

Appendix 1

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How tips are taxed

Whether you are a waiter or a taxi driver, if you get tips (even cash tips), you cannot just put them in your pocket or bank account and be done with it! Here we explain how tips are taxed and tell you how to stay on the right side of HMRC.

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Content on this page:

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- Keep an eye on your tax code
- Can I use the trading allowance to cover my tips?
- Electronic tipping
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Tips are an important source of income for many low-paid workers, particularly in the hospitality sector but also in other sectors such as hairdressing and taxi driving.

If you get tips, you need declare them properly for the purposes of tax and, where applicable, tax credits and universal credit. This applies whether you are an employee or self-employed, and whether you get them in cash or in another way. Just because tips don’t count as income for National Minimum Wage purposes, that doesn't mean they don't count as income for other purposes!

What are the rules on tips for employees?

Some customers leave tips in the form of a service charge or by adding it on to a debit or credit card payment. When a customer pays a tip directly to the employer in this way, there is currently no legal requirement for employers to pass on the amount on to their employees (either fully or in part).

Where some or all of the amounts are passed on by the employer, then the employer must operate Pay As You Earn (PAYE). This means that your tax and National Insurance (NIC) liabilities on the tips should be deducted before you receive them. This also means that you should not have to do anything else to notify HMRC or DWP about your tips for tax, tax credits or universal credit purposes.

A similar situation occurs where tips are paid via something called a 'tronc'. A tronc is where tips are pooled and where someone other than the employer (a head waiter or waitress for example) controls and distributes them. Tips paid through a tronc should be taxed before you receive them. But if the tronc is set up correctly, tips can be paid NIC-free through the scheme. This saves you money.

You can find HMRC's booklet E24 on GOV.UK. This contains guidance on tips, service charges and gratuities and explains how troncs should be operated. Please note that although this guidance is aimed at employers, employees may find it useful too.

You can also find more information about tips at work on GOV.UK, including a link to a voluntary Code of Best Practice on tips that suggests how employers should handle them.

Cash tips

If an employee gets cash tips directly from a customer without the employer being involved, the tips belong to the employee. This includes any change left on the table by a customer for the employee, any cash handed to the employee and any money left in a tip box or dish by the till to be informally shared out (in which case it belongs to the employees as a group).

Although tips do not count as 'income' towards the National Minimum Wage – meaning that you should receive the minimum wage with any tips on top – cash tips should not be thought of as a 'gift'. Rather, they are classed as employment income which means they are taxable (but not NICable) on you. While they are taxable, there will not be any tax deducted from them. This means you are responsible for telling HMRC about these tips, however this is possibly often overlooked.

As such, and to stay on the right side of HMRC, we suggest:

Keep a good record of your tips

You will have to show cash tips received on your Self Assessment tax return (if you fill one in). If, as in many cases, you do not have to fill in a tax return because all your income is taxed under PAYE, you should tell HMRC about your cash tips. HMRC will usually adjust your tax code to collect the tax due. Otherwise, they may send you a bill at the end of the tax year or ask you to fill in a tax return.

You can tell HMRC to adjust your tax code via your Personal Tax Account or by phoning the HMRC Income Tax Helpline on 0300 200 3300 (textphone 0300 200 3319). Have your National Insurance number with you when you phone. It is a good idea to make a note of the date and time of your call, as well as the name of the adviser that you speak to and what is said.

To adjust your tax code, HMRC will need to know how much you received in cash tips. This means that you have to keep a good record of what you have received. If you do not do this, HMRC may estimate your tips. This might be a rough calculation based on the sales of the restaurant and the number of employees. This could lead to an overestimation of your cash tips and you paying more tax than you need to.

Don't forget about tax credits and universal credit

The meaning of employment income for tax credits and universal credit broadly follows employment income for tax purposes. As such, any tips you receive may be counted as employment income for benefits purposes.

HMRC use the employment income information provided on an employer's Real Time Information (RTI) payroll reporting for universal credit and as part of the tax credits renewals process. Tips that are paid through PAYE (including under a tronc) will be included on RTI payroll reporting and will be automatically picked up for universal credits and tax credit renewals.

RTI payroll reporting will not show cash tips, so unless you declare them as employment income to HMRC or DWP yourself, your benefits award might be wrong. This could result in your receiving too much money in benefits and possibly a penalty.

Keep an eye on your tax code

Once HMRC have 'coded in' an amount in respect of your tips, this is not the end of the story. Make sure you check your PAYE coding notice regularly to check if the amount is still accurate. If you do not do this, and the amount of tips you receive goes down, you will end up paying too much tax. If the amount of tips you receive goes up but the amount in your code stays the same, you could end up owing HMRC money.

Can I use the trading allowance to cover my tips?

Tips are taxable as employment income because even though they are given to you by a customer, they relate to an employment.

The trading allowance allows you to get a small amount of 'miscellaneous' or trading income before you need to report it or pay tax on it. Unfortunately, employment income is not covered by this, meaning that you have to pay tax on your tips from the very first £1!

Electronic tipping

Cashless tipping is becoming more common. Methods of cashless tipping include apps which customers can download to make tips, and links or QR codes that customers can use to make tips. Sometimes there might be a physical terminal that customers can tap with a contactless card.

HMRC have recently updated their E24 guidance on tips, gratuities, service charges and troncs to confirm that the basic principles apply to cashless tips. This means:

- Where cashless tips are received, managed and then distributed by the employer, the employer must operate tax and NIC via PAYE – as they would for any other tips controlled by the employer.

- Where cashless tips are pooled and then processed via a tronc, then the usual tronc rules will apply.

- Where cashless tips are paid directly to the employee without the employer's involvement (for example by the app) – then these are treated like cash tips. The employee will need to declare them to HMRC. We understand that the customer usually pays any fees for making an electronic payment, however, sometimes fees or commissions may be paid by you. Although they may be deducted from your tips before they are distributed to you, it is our understanding that strictly, you should be declaring the gross amount to HMRC (that is, the tips before any deductions). We will seek to clarify this point with HMRC.

What if I am self-employed?

Tipping is common in many lines of self-employed work. If you are a self-employed tradesperson, beautician, driver, online performer (or anything else!) it is important to include all tips you receive in your sums when working out your self-employed income for your tax return. This includes tips from cash, cards or electronic apps.

If you are on tax credits, tips included on your tax return should be automatically included when your claim is calculated by HMRC. If you are on universal credit you should make sure tips are included in your monthly assessment of self-employment income when you report the figures to DWP.

If you have a main job (an employment) but make some tips from doing something different on the side, then it may be possible to use the trading allowance. But what if you have an existing self-employed business and make some tips by doing something different on the side? If it is only a small amount, can you use the trading allowance?

Sadly not. As we say above, the trading allowance can cover up to £1,000 of miscellaneous or trading income. However for the purposes of the trading allowance, the income from all an individual's activities (such as casual earnings and self-employment income) is combined.

So, say Jason is a self-employed carpenter and earns £30,000 a year (from having sales of £34,000 and expenses of £4,000) but at the weekend, he plays gigs in local pubs and receives some tips. Over the course of a year, the tips total £800. Once you add together the money from the carpentry and the money from the tips, it is more than £1,000 so Jason can't use the trading allowance to cover the tips. This is even though the income is from a completely different type of work and the nature of the money is different.

Where you have miscellaneous or trading income over £1,000 you can deduct the amount of the trading allowance instead of actual expenses, which can help save you money. However Since Jason is already self-employed and has expenses above the trading allowance, this doesn't work either.

There is information on our page 'What is the trading allowance?' which includes examples if you have more than one source of trading, causal or miscellaneous income.