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IN FOCUS

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Taxation of Tip Income

Federal law generally requires workers to pay individual income taxes and the payroll taxes on their tip income, as on other compensation. Lawmakers are considering making some tip income exempt from the individual income tax, and have introduced other proposals to exempt such income from payroll taxes. This In Focus explores the tax treatment of tips and the potential consequences of exempting tip income from taxation.

Current-Law Treatment of Tips

Payroll Taxes

Tips are generally considered wages for payroll tax purposes. Federal payroll taxes include taxes on both the employee and employer of 6.2% of a worker's wages up to a taxable maximum ($76,100 in 2025) to finance the Social Security trust funds, as well as of 1.45% of a worker's wages to finance the Medicare Hospital Insurance trust fund; these taxes are commonly referred to as Federal Insurance Contribution Act (FICA) taxes. Individuals also pay an Additional Medicare Tax of 0.9% on compensation exceeding $200,000 ($250,000 for couples married filing jointly; $125,000 if married filing separately). The Tax Policy Center estimates that roughly 67% of households with incomes below $100,000 in 2023 paid or generated more in payroll taxes than in individual income taxes, including both the employer- and employee-side taxes.

Employers must pay the employer portion of payroll taxes on tips that their employees receive. Food and beverage businesses at which tipping is customary can receive a credit against their *income* tax liability for FICA taxes paid on tips exceeding the amount needed to meet a wage of $5.15 per hour for each tipped employee.

Employers also pay a Federal Unemployment Tax Act payroll tax. This tax is usually worth 0.6% (net of credits for state unemployment taxes) on each employee's first $7,000 earned, including tips. Employers (and employees, in some states) also pay state unemployment insurance taxes, the rules for which differ by state.

Income Tax

The individual income tax applies to "all income from whatever source derived" unless excluded by law. The tax applies to tips, including cash tips not reported to an employer. Tips that are part of a taxpayer's gross income are considered earned income. Earned income is important for calculating the earned income tax credit (EITC) and the refundable portion of the child tax credit, known as the additional child tax credit (ACTC).

Withholding and Reporting Tips

Workers must report tips exceeding $20 per month to their employers, who must in turn withhold FICA taxes on them when possible and report the tips to the Internal Revenue Service (IRS). Businesses must include tips received by their workers as part of gross receipts when filing their own taxes, but can deduct them as employee compensation.

Food or beverage establishments with 10 or more employees at which tipping is customary may have to "allocate" tips to employees. Tips are allocated to employees if their reported tips are below their share of 8% of food and drink sales. Even with this backstop, the IRS has said that "the lack of complete information reporting and the cash nature of many tips suggest that tip income has a lower compliance rate than other wages and salaries and is harder to detect during an audit."

The Tipped Workforce

The IRS reports that in 2018 (the most recent year available) roughly $38 billion in tips were reported on the W-2s associated with 6 million income tax returns. While the average tipped income reported on W-2s in that year was roughly $6,000, the median among tipped workers was about $2,600. This suggests that (reported) tip income is relatively concentrated among a subset of tipped workers.

The Budget Lab at Yale University estimates that fewer workers, roughly 4 million, worked in tipped occupations in 2023 based on Census Bureau data. Workers in tipped jobs were disproportionately lower earners. The estimated median weekly wage for tipped workers was $538 (including tips), compared to roughly $1,000 for nontipped workers.

The Budget Lab also estimated that 37% of tipped workers had too little income in 2022 to pay income tax before accounting for tax credits. This suggests a relatively large share had no or little income tax liability. Most such workers still likely paid payroll taxes.

Proposals for Exclusion from Tax

Lawmakers have introduced legislation in the 119th Congress to exempt tip income from some or all income and payroll taxation. As passed by the House, Section 110101 of H.R. 1, the One Big Beautiful Bill Act, would create a new income tax deduction for qualified tip income for tax years 2025 through 2028, which could be claimed in addition to the standard deduction. Qualifying tips could include those received in non-employee arrangements (such as independent contracting), and would be limited to those in occupations that traditionally receive tips and that are paid voluntarily, without negotiation. Taxpayers could not claim the deduction if they receive earned income in excess of the highly compensated employee threshold ($160,000 in 2025) or if they work in a specified service trade or business for purposes of the qualified business income deduction. Workers would still report tips as part of their gross income, and would owe payroll taxes on tips. The bill would also extend a modified tip credit to certain beauty service businesses.

Lawmakers considered other structures for a tip tax benefit in the 118th Congress. For example, H.R. 8785, the Tax Free Tips Act, would have classified tips as gifts and thus excluded them from workers' gross incomes subject to the income tax. The bill would also have excluded tip income from the payroll taxes. H.R. 7870, the Tip Tax Termination Act, would have excluded the first $20,000 a worker receives in tips from gross income and from the payroll taxes through December 2028. The bill would have required transfers from the General Fund to the payroll tax-financed trust funds to hold those funds harmless from the change.

Distributional Impacts of Excluding Tip Income from Taxation

Excluding tip income from taxation would raise after-tax incomes for tipped workers, but not for nontipped workers with similar incomes. To the extent tipped income is more likely to go unreported, some of this disparity may already be present in the tax system. Policymakers may approve of such a disparity if they believe there is a substantive difference between tipped and nontipped workers.

The impact of such a policy could also vary by taxpayers' incomes. Most low-wage workers are not in tipped occupations, but those in tipped occupations earn less, on average, than other workers. Workers in tipped occupations who owe no or little income tax because they have low incomes would benefit little, if at all, from excluding tips from income subject to tax. Those who face higher marginal tax rates—generally, those with higher incomes—would benefit more than those facing lower rates.

If exempting overtime pay eliminates some or all of taxpayers' income tax liability, such taxpayers would lose some or all of their benefit from nonrefundable credits, which must be claimed against positive income tax liability. Policy structures that omit tip income from a taxpayer's gross income could also affect whether such taxpayers qualify for some refundable tax credits—such as the earned income tax credit (EITC) and the refundable portion of the child tax credit, known as the additional child tax credit (ACTC)—that phase in with income. Excluding tips from gross income could also make some individuals no longer qualify for some federal benefits, including those through certain health programs.

For the workers (particularly lower-income workers) who pay more in payroll taxes than income taxes, excluding tips from payroll taxes would provide a larger benefit than excluding tips from income taxation would. Doing so could also benefit those who employ tipped workers.

The Tax Policy Center estimates that letting workers deduct tipped income and exclude it from the payroll tax base would give 3.3% of filers an average benefit of $2,170. Among the lowest-earning quintile, an estimated 5.5% of filers would benefit, receiving an average of $730. Limiting the benefit to an income tax deduction for households with AGI below $75,000 would benefit an estimated 1.5% of households by an average of $1,150 (1.4% and $460 in the lowest-earning quintile).

Economic Impact of Excluding Tip Income from Taxation

Labor Supply

Reducing taxes on labor income effectively raises the tipped worker's after-tax wage. This creates two countervailing effects on workers' decisions regarding whether and how much to work. A higher hourly wage means that workers can achieve the same take-home pay while working *fewer* hours than would be required if such income were taxed. However, a higher effective wage means that workers forgo more money for each hour they spend not working, placing upward pressure on labor supply hours. The net effect on labor supply will depend on which effect dominates.

Estimates of the effect of raising after-tax wages on labor supply vary. However, a review of the literature found that workers—particularly lower earners—tend to work more when the return to work rises.

Impact on Federal Revenue

Excluding tips from taxation would reduce revenues. The Joint Committee on Taxation estimated that the tip provision in H.R. 1 would reduce federal revenues by $40 billion from FY2025 to FY2034. Most of the revenue effect would be concentrated in FY2026-FY2029, when the deduction would be in effect. The Committee for a Responsible Federal Budget estimates that excluding tips from both income and payroll taxes could raise deficits by $150 billion to $250 billion from FY2026 to FY2035. The committee also estimates that the cost would be $125 billion to $225 billion if provisions of P.L. 115-97 (commonly known as the Tax Cuts and Jobs Act) that Congress scheduled to expire in 2025 are instead extended permanently.

Reducing payroll tax revenue, specifically, could also worsen the financial condition of the trust funds that finance Social Security programs and Medicare Hospital Insurance if lawmakers do not pair the change with other offsetting policies, such as transfers from the General Fund.

Popularity of Tipping

Providing a tax advantage to compensation through tips that is not available for other forms of compensation could make tipping more desirable for workers and employers. All else equal, workers might prefer receiving their pay in the form of tax-advantaged tips rather than taxed wages or salaries. Employers, in turn, could better compete for workers by offering compensation in tips. Employers would also benefit from the share of any foregone employer-side payroll tax they retained, rather than passed on in the form of lower wages. Customer resistance to broader tipping expectations or worker preferences for stable levels of income could counteract these incentives.

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