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Taxation of Tip Income Under the 2025 Reconciliation Law

Federal law generally requires workers to pay individual income taxes and payroll taxes on their earned income. The 2025 reconciliation law (P.L. 119-21) created a new temporary deduction for up to $25,000 per household in tipped income for tax years 2025 through 2028. The law also expanded a business tax credit that offsets the cost of some employer payroll taxes paid on tipped income to those in the beauty industry. This In Focus explores the tax treatment of tipped income and potential effects of these reforms.

Deduction for Tipped Income

The individual income tax applies to "all income from whatever source derived" unless excluded by law. The tax has historically applied to tips, including cash tips not reported to an employer.

The 2025 reconciliation law created a new temporary deduction for some tipped income. From tax years 2025-2028, taxpayers can deduct up to $25,000 for qualified tip income (not adjusted for filing status). The deduction is reduced by $100 for each $1,000 the filer earned above $150,000 ($300,000 for those married filing jointly). It phases out fully for filers earning above $400,000 ($550,000 for those married filing jointly) who claim the maximum deduction.

Qualified tip income is cash tips received through work in an occupation that traditionally and customarily receives tips, as identified by the Department of the Treasury, which released a preliminary list of such professions in September 2025. Qualifying tips must be paid voluntarily, determined by the payor, and not subject to negotiation, among other rules. The provision is only available if tips are reported on an information return. Tips earned by nonemployee workers (such as independent contractors) can qualify to the extent they exceed the cost of goods sold and other expenses, losses, or deductions allocable to the service provided. Tip income from "specified service trades and businesses," as defined for purposes of the qualified business income deduction, does not qualify for the tip deduction.

Taxpayers can claim this deduction in addition to the standard deduction. It will not affect their adjusted gross income, which is used to determine eligibility for certain federal benefits or tax credits and deductions. The deduction is only available to taxpayers if they have a work-authorized Social Security number, and is disallowed for those married filing separately. Taxpayers cannot claim both the qualified business income deduction and the tip deduction for the same income.

The deduction effectively exempts qualified tip income from *income* tax. However, that tip income is still subject to *payroll* taxes (such as for Social Security and Medicare hospital insurance). Absent congressional action, this deduction will expire in tax year 2029.

Payroll Taxes and the FICA Tip Credit

Tips are generally considered wages for payroll tax purposes, both now and prior to passage of the 2025 reconciliation law. Federal payroll taxes include taxes on both the employee and employer of 6.2% of a worker's wages up to a taxable maximum ($176,100 in 2025) to finance the Social Security trust funds, as well as a tax 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 more in payroll taxes (including both employee- and employer-side taxes, as employers may pass the employer-side tax onto workers in the form of lower wages) than in individual income taxes.

Employers must pay the employer portion of payroll taxes on tips that their employees receive, and certain businesses may qualify for a tax credit based on the amount paid. 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 total wage of $5.15 per hour for each tipped employee (known as the *FICA tip credit*). The 2025 reconciliation law permanently expanded eligibility for the FICA tip credit to certain beauty service businesses, with modifications. Eligible beauty service businesses are those involved in barbering and hair care, nail care, esthetics, and body and spa treatments at which tipping is customary. For such businesses, the credit is calculated based on the tips needed to meet the federal minimum wage during the month in which the tips were received, rather than $5.15 per hour. The calculation of the credit for food and beverage businesses is unchanged.

Employers also pay a Federal Unemployment Tax Act payroll tax. This tax is usually 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.

Withholding and Reporting Tips

Tipped income must be reported to the Internal Revenue Service (IRS) for taxpayers to claim either the new tip income deduction or the FICA tip credit. As under prior law, 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 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. Most such workers still likely paid payroll taxes.

Distributional Impacts

Excluding tip income from taxation raises the after-tax incomes for qualifying tipped workers, but not those of nontipped workers with similar incomes. To the extent tipped income is more likely to go unreported, some of this disparity may have already been 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 Tax Policy Center estimates that the new tip tax deduction will benefit roughly 2.6% of households in tax year 2026. About 44% of these households will earn over $100,000 in expanded cash income (which includes both adjusted gross income and some other income sources, such as certain employer benefits), and such households will receive roughly 69% of the benefit of the deduction.

The impact of the deduction varies by taxpayers' incomes for several reasons. First, workers in tipped occupations who previously owed no or little income tax (because of their low incomes) will 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—will benefit more than those facing lower rates.

If exempting tipped income eliminates some or all of taxpayers' income tax liability, such taxpayers could also lose some or all of their benefit from nonrefundable credits, which must be claimed against positive income tax liability.

Lastly, many low-income workers pay more in payroll taxes (which the deduction does not affect directly) than income taxes. Excluding tips from payroll taxes would provide a larger benefit for lower earners than excluding tips from income taxation would.

Economic Impact

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 reduces federal income tax revenues. In July 2025, the Joint Committee on Taxation (JCT) estimated that the tip provisions in the 2025 reconciliation law will reduce federal revenues by $32 billion from FY2025 to FY2034. Most of the revenue effect would be concentrated in FY2026-FY2029, when the deduction would be in effect. In December 2025, JCT estimated that the tip deduction specifically (excluding the expanded FICA Tip Credit) will reduce federal revenues by $28.6 billion from FY2025 to FY2029.

Popularity of Tipping

Providing a tax advantage to compensation through tips 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. The limits on professions able to claim the deduction, customer resistance to broader tipping expectations, or worker preferences for stable levels of income could counteract these incentives. The deduction provides no additional incentive to receive or pay compensation in tips beyond the $25,000 limit on the deduction.

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