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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 have introduced several bills in the 118th Congress to exclude tip income from the individual income tax, and in some cases, from payroll taxes. This In Focus explores the tax treatment of tips and the potential consequences of excluding 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 ($168,600 in 2024) 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. While tipped workers comprised 2.5% of total employment, they made up 4% of employment in jobs earning below $25 per hour (i.e., the bottom half of the hourly wage distribution) and 5% of those earning below $17.66 per hour (bottom quarter). 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 118th Congress to exclude tip income from some or all income and payroll taxation. S. 4621, the No Tax on Tips Act, would let taxpayers deduct cash tips reported to their employers from income subject to the individual income tax. As an above-the-line deduction, taxpayers could claim this deduction even if they also claimed the standard deduction. Workers would still report tips as part of their gross income and would owe payroll taxes on tips.

H.R. 8785, the Tax Free Tips Act, would classify tips as gifts and thus exclude them from workers' gross incomes subject to the income tax. The bill would also exclude tip income from the payroll taxes. H.R. 7870, the Tip Tax Termination Act, would exclude the first $20,000 a worker receives in tips from gross income and from the payroll taxes through December 2028. The bill would require 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

Horizontal Equity

Economists tend to think of distributional impacts in two ways. The first is horizontal equity, or the distribution of a burden or benefit among different types of workers with the same incomes. Excluding tip income from taxation would create a horizontal disparity because it would raise the after-tax incomes of some tipped workers without offering a similar benefit to 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 find a horizontal disparity tolerable or desirable if they believe there is a substantive difference between the groups that justifies it—in this case, between tipped and nontipped workers.

Vertical Equity

Another way economists consider distributional impact is vertical equity, or the share of a burden or benefit among similar types of workers of different 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 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.

Excluding tips from income taxation could also affect the value of other tax benefits. Taxpayers would lose most or all of their benefits from nonrefundable credits, which must be claimed against income tax liability, if excluding tips eliminated most or all of that income tax liability. Omitting tips from income taxation could also affect whether workers qualify for some refundable tax credits, such as the EITC or ACTC, which phase in with earned income. Other taxpayers might become newly eligible for tax benefits such as the EITC if their benefit had otherwise begun to phase out. (H.R. 7870 would continue counting tips as earned income for purposes of the EITC and ACTC.)

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, so long as their employer-side payroll taxes would have exceeded their tip credits against income taxes.

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. This creates a disincentive to work additional hours, known as the "income effect." However, a higher effective wage means that workers forgo more money for each hour they spend not working. An associated "substitution effect" places 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 by the Congressional Budget Office found that workers generally tend to participate in the labor force more often, and work more hours, when the after-tax return to work rises. These responses were generally modest, particularly for men and single women, but were stronger for lower earners.

Impact on Federal Revenue

Excluding tips from taxation would reduce revenues. 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, as opposed to taxed wages and salaries, more desirable for workers and employers. Workers would presumably prefer to receive their pay in the form of tips if such tips were excluded from some or all federal taxation, all else equal. Employers, in turn, could better compete for workers by offering compensation in untaxed tips rather than taxed wages or salaries. 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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