

No Tax on Tips

Dear Client,

Do you or someone you know could benefit greatly from no tax on tips? Here's what you need to know. Starting in 2025, eligible workers can deduct up to \$25,000 of qualified cash tips from their federal taxable income as an above-the-line deduction, meaning it can be claimed without itemizing. This deduction applies only to federal income tax, not Social Security or Medicare (FICA) taxes, which will still apply. The deduction phases out by \$100 for every \$1,000 of modified adjusted gross income (AGI) above \$150,000 for single filers or \$300,000 for joint filers.

Tax Consequences

- **For Employees:** The deduction reduces federal income tax liability on tips, potentially increasing take-home pay after filing taxes. However, employees must still report all tips to their employer, and FICA taxes are withheld as usual. If tips are underreported, employees face a 50% penalty on Social Security and Medicare taxes owed, plus a potential 20% IRS penalty.
- **For Employers:** Employers must continue withholding and reporting federal income, Social Security, and Medicare taxes on tips. The new law expands the FICA tip credit to include beauty service industries (e.g., hair, nail, spa services) in addition to food and beverage establishments.

What Employees Can Expect

- **Increased Take-Home Pay (After Filing):** Employees in qualifying tipped occupations can deduct up to \$25,000 of reported cash tips from their federal taxable income when filing their 2025 tax return (due in 2026).
- **No Immediate Paycheck Change:** The deduction is applied when filing taxes, not during payroll. Employees may adjust their W-4 forms to reduce withholding, anticipating the deduction, which could increase their current paycheck's net amount. However, this requires careful planning to avoid under-withholding and potential tax penalties.
- **Continued FICA Taxes:** Social Security and Medicare taxes (7.65% combined) are still withheld on all reported tips, ensuring no impact on future Social Security benefits but reducing immediate paycheck amounts compared to a full tax exemption.

What Employers Can Expect

- **Continued Tax Withholding and Reporting:** Employers must withhold federal income, Social Security, and Medicare taxes on reported tips and report them on Form W-2 (Boxes 1, 5, and 7).

The new law requires separately identifying total tips on W-2s, but overall reporting processes remain largely unchanged.

- Potential Behavioral Shifts: Employers may face pressure to reclassify wages as tips to maximize employee benefits, though the law limits this by restricting deductions to traditionally tipped occupations. Employers should consult legal and tax professionals to avoid improper reclassification.

Yours truly,

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