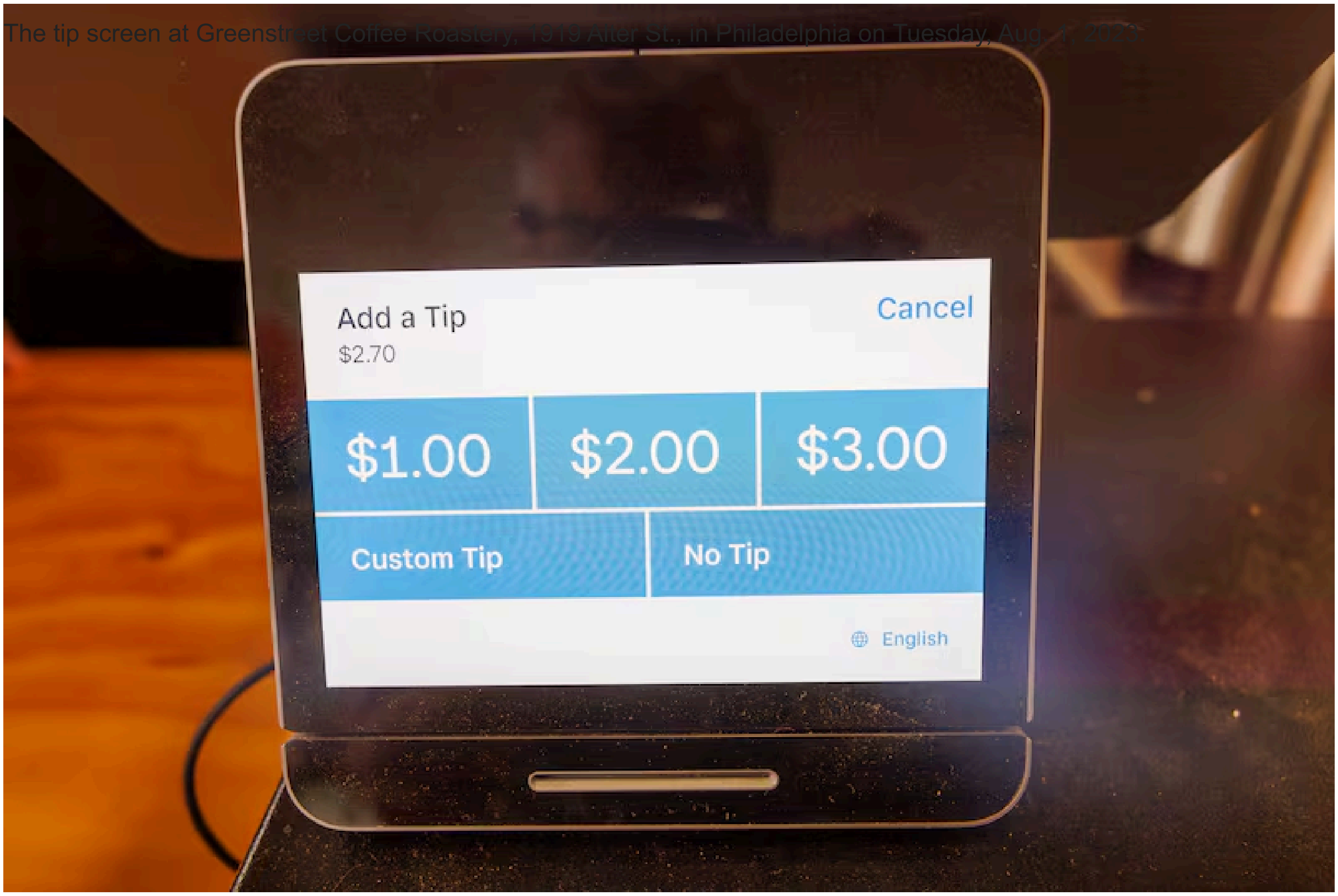
No tax on tips: What businesses and workers should know

Accountants give their tips on how workers and employers should approach tipped income under new tax rules.



The tip screen at Greenstreet Coffee Roastery, 1919 Alter St., in Philadelphia on Tuesday, Aug. 1, 2023.

by Gene Marks, For The Inquirer
Published Sept. 16, 2025, 5:00 a.m. ET

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The tax and spending bill passed by Congress and signed into law by the president on July 4 contained many provisions that impact both individuals and businesses. One that received a lot of attention eliminates taxes on some tipped wages.

So what does this mean? Here are a few things both companies and their employees need to know.

Only a certain amount of tipped income is now exempt from federal income taxes

The total deduction is $25,000 per year and starts phasing out once Modified Adjusted Gross Income (defined as your total income minus certain deductions like loan interest and IRA contributions) reaches $150,000 for a single filer or $300,000 for those filing joint returns.

The “tipped” income may be made voluntarily by customers either by cash, credit cards, or a tip-sharing arrangement.

There are other limitations for self-employed people — for example the deduction cannot exceed net income from that trade or business. Some estimate that a third of all workers won’t benefit from this rule because they don’t earn enough to pay federal taxes.

“It’s definitely going to be good for people who are under those thresholds. Those who will be able to take advantage of this new rule will have some savings there for sure,” said Alex Jones, a certified public accountant at Brinker Simpson & Co. in Media.

“But if you’re a higher earner, this is where it’s not going to really be effective to you, or it’s not really going to matter, because you’re going to phase out of these write-offs,” Jones said.

Not all taxes are exempted

Social Security (FICA) and Medicare taxes will still be required by employees, along with matching payments from employers. Jones says other taxes may also apply.

"Besides FICA and Medicare, these wages are also still going to be subject to potential state and local income tax," he said.

Only certain workers are eligible

There are 68 types of workers eligible for this deduction, including those working in the beverage and food, entertainment and events, hospitality and guest services, home and personal services industries, as well as personal appearance, well-being, recreation and instruction.

The proposed list of jobs is expected to be officially written into the Federal Register in early October. Some jobs included on the list aren't a surprise — like bartenders, wait staff, and barbers. Others include home service electricians, plumbers, locksmiths, and private event planners.

Be careful about state tip credits

Local employers have historically taken advantage of a credit for their tipped workers where they're allowed to pay a reduced minimum wage to their tipped employees, assuming that the workers earn a minimum amount through tips.

For example, Pennsylvania employers can pay their workers $2.83 per hour, which is below the state's $7.25 hourly minimum wage, as long as their employees make up the difference through tips. In New Jersey, it's $5.62 per hour.

Because this is a state rule, the employees eligible for this credit are not the same as those eligible for the federal tipped wages deduction above, so employers need to be careful.

W-2 forms will change

The new rule requires employers to report the amount of each employee's qualified tipped income. However, the W-2 form, which is used to report income to the Internal Revenue Service, will remain unchanged for 2025 and the IRS is expected to come out with reporting guidance for employers shortly.

For 2026, the W-2 form will change, with a new section available for employers to separately report this amount. A proposed W-2 has been released by the IRS but not finalized.

Linda Scheer, a tax manager and certified public accountant at J. Cohen CPAs & Advisors in Philadelphia, said because of these changing rules, it's critical that payroll teams, whether in-house or third-party, are informed and have the systems in place to accurately track and report this data.

"Communicating and encouraging employees to review their pay stubs throughout the year can also prevent year-end surprises," she said.

"If the qualified amounts reported don't match an employee's expectations, it could be a challenge to track down discrepancies," Scheer added. "Preparing early, setting up the right processes, and maintaining transparency will help employers set themselves up for success."

The benefit is only claimed when tax returns are filed

The only way for employees to take advantage of this is to claim the deduction on Schedule 1 of their individual tax return after the year ends. The deduction can be taken even if expenses aren't itemized.

"It's really imperative that employers make sure they are tracking tipped income effectively because the deduction for their employees is going to be made at the individual level," said Jones. "The employees, when they receive their W-2s at the end of the year, are going to need the information to be able to determine eligibility."

The tax benefit is temporary

The benefit applies to tax years 2025 through 2028. That means it will come due about the time of the next presidential election, so you can expect its extension will become an election-year issue.

Regardless of the restrictions and its temporary nature, the benefit will be helpful to many over the next few years.

“For those who qualify, the tips income deduction can provide a meaningful federal tax savings,” says Scheer. “Additionally, the tips income deduction and overtime income deduction may help some taxpayers qualify for other tax credits they wouldn’t otherwise be eligible for, by lowering adjusted gross income. For eligible taxpayers, this is a win.”

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