



# Is There Really No Tax on Tips?

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## Key Takeaways

- “No tax on tips” is more complex than the name suggests and will not result in an across-the-board tax cut for those who qualify.
- Taxpayers seeking to claim the “no tax on tips” deduction should be aware that it applies only to individual income taxes and does not exempt payroll taxes.
- A variety of factors will contribute to how the deduction actually affects taxpayers. Keeping accurate records of all tip income is essential for workers who believe they may qualify for the credit.

Taxpayers can expect a lot of changes in the upcoming tax season thanks to the One Big Beautiful Bill Act (OBBBA) signed into law on July 4, 2025. In addition to making permanent tax cuts from the Tax Cuts and Jobs Act (TCJA) of 2017, the law includes new temporary provisions affecting the taxation of tips, overtime, and car loan interest as of the beginning of 2025.

New information is being released about changes in taxpayers' obligations, with a growing focus on "no tax on tips." As new guidance, including [IRS guidance](#) released on September 19, helps taxpayers understand whether they qualify for the deduction, there is one important caveat to remember about the policy: it only applies to federal income taxes. Earners will still be required to pay payroll taxes on tip income and could face penalties for noncompliance.

The tax break is more complex than the "no tax on tips" name suggests and will not result in an across-the-board tax cut for those who qualify. Payroll taxes and a variety of other considerations, from state laws to filing status, will contribute to how the deduction actually affects taxpayers. Therefore, keeping accurate records of all tip income is essential for workers who believe they may qualify for the credit.

### Tip Income Reporting

For earners with tip income, now may be a good time to brush up on tip income tax reporting requirements. Over the past few years, the IRS has published a variety of [informative resources](#) for tip-income earners, encouraging taxpayers to keep a daily tip record, report all tips to their employer, and report all tips on federal income taxes. IRS [Form 4070-A](#) is available to earners who wish to use it as their tip record, but taxpayers are free to use their preferred recording method. Employers must withhold payroll taxes on reported tips and include this information in W-2 statements.

The IRS has also developed several regulatory regimes to ensure that both employers and employees are accurately recording and reporting tip income. This includes voluntary programs such as the Tip Reporting Alternative Commitment (TRAC), the Employer-Designed Tip Reporting Alternative Commitment (EmTRAC), the Tip Rate Determination Agreement (TRDA), and the Gaming Industry Tip Compliance Agreement (GITCA). These agreements between employers and the IRS serve to reduce the audit risk for businesses that proactively attempt to increase their employees' tip income reporting.

Nevertheless, the Treasury Inspector General for Tax Administration (TIGTA) finds that billions of dollars of [tip income](#) continue to go unreported, even when employers voluntarily enter agreements with the IRS. In 2018 TIGTA reported that 72% of unreported tip income occurred at establishments that were part of the TRAC program. In response, the IRS in 2023 attempted to implement a more aggressive form of tip compliance through the Service Industry Tip Compliance Agreement (SITCA). [SITCA](#) would have replaced all other programs, except for those specific to the gaming industry, with a uniform program. It also would have reduced audit protections for participating employers, which was seen as the major benefit of past regimes. SITCA [drew criticism](#) for its reliance on monitoring employees' point-of-sale and attendance systems, thus it has not been finalized.

### Income Taxes

The new tip tax deduction exempts tip income from federal income taxes up to \$25,000 per year per individual, phasing out once the taxpayer's modified adjusted gross income reaches

\$150,000. For joint filers, the deduction exempts up to \$50,000 in tipped income, phasing out for modified adjusted gross income up to \$300,000. The deduction is temporary, ending at the end of 2028. Taxpayers can claim the deduction regardless of whether they itemize their deductions or claim the standard deduction.

Taxpayers seeking to claim the “no tax on tips” deduction should be aware that it applies only to individual income taxes. Taxpayers pay federal income taxes on all income at a rate determined by their [tax bracket](#). For 2025, a single worker with income of \$45,000 would have a tax rate of 10% of their taxable income under \$11,600 and 12% on their taxable income over \$11,600. Single taxpayers are eligible to claim the standard deduction, reducing their taxable income by \$15,000. [Individual income](#) tax rates were lowered and the standard deduction was raised through the Tax Cuts and Jobs Act (TCJA) of 2017, with these changes being made permanent in the OBBBA.

Beyond tax rates and the standard deduction, other credits and deductions also reduce taxpayers’ taxable income. The Child Tax Credit (CTC) and Earned Income Tax Credit (EITC). Credits and deductions frequently wipe out low-income earners’ federal income tax liability entirely. In 2022, nearly 51 million taxpayers—nearly all earning less than \$50,000—owed no [federal income](#) tax at all.

## Payroll Taxes

Workers with tip income need to be aware that they will still owe payroll taxes on their tip income. Payroll taxes are separate from federal individual income taxes and are levied at a flat rate of 7.65% paid by both the employer and the employee. For each share, 6.2% is dedicated to Social Security and 1.45% to Medicare. For employees’ purposes, reporting additional tip income to an employer will result in the employer withholding the 7.65% payroll tax on the reported tip income, as well other withholdings such as state unemployment tax.

[Payroll taxes](#) are among the largest but least visible taxes for lower-income earners. As of 2023, [nearly 70%](#) of earners with annual income below \$100,000 paid more in payroll taxes than federal income taxes. In 2021, only about 40% of taxpayers owed any federal income tax, compared to 75% of taxpayers who owed [payroll taxes](#).

In terms of other new individual income tax deductions created by OBBBA, payroll taxes are a more important consideration for tipped workers than overtime earners. Employers withhold Federal Insurance Contributions Act (FICA) taxes for Social Security and Medicare, so employees generally do not have to run any calculations themselves for overtime income. Since tipped income is largely self-reported, employees will need to communicate changes in tip income with their employers to ensure that both their share and the employer’s share of payroll taxes are properly paid.

## Claiming the “No Tax on Tips” Deduction

Not all tipped workers will be eligible for the new deduction. On September 19, the Department of the Treasury and IRS released the first [proposed guidance](#) on the tip tax deduction. The draft includes a list of nearly 70 occupations that would be eligible to claim the deduction and defines qualified tips. By law, the IRS was required to produce a list of potentially eligible occupations by October 2.

In addition to guidance, the IRS has released draft form [Schedule 1-A](#) and [draft W-2](#) form for 2026 to claim the new deductions. The newly released Schedule 1-A helps taxpayers determine that their MAGI is within the range to claim the full “no tax on tips” deduction. Taxpayers are instructed to enter their qualified tips if their Medicare wages and tips from their W-2 is \$176,100 or less, accounting for the phaseout threshold and the standard deduction.

The guidance notes various factors used to determine eligible occupations and define qualifying tips. OBBBA specifies that eligible occupations should be those that “customarily and regularly received tips on or before December 31, 2024.” The IRS identifies nearly 70 qualifying occupations using a newly created Treasury Tipped Occupation Code (TTOC) system that differs from the traditionally used Standard Occupational Classification (SOC) system. The list was crafted using W-2 and Form 4137 information, data from the GITCA program, the House Budget Committee’s OBBBA report, and [U.S. Department of Labor](#) information.

The guidance also clarifies what counts as cash tips. Cash tips can include tips paid by credit and debit cards, casino chips, or gift cards. While the guidance specifically excludes “most digital assets” from cash tips, it could leave the door open for certain stablecoin tip payments due to their fixed value. The IRS will likely have to further clarify its definition of cash tips in its final rule.

Importantly, the guidance reiterates the OBBBA’s requirement that tips be voluntary. This could have wide-ranging consequences for state and [local governments](#) that deviate from the federal tip minimum wage by requiring a higher minimum wage for tipped workers. Many restaurants respond to these laws by adding a mandatory [service charge](#) to a customer’s bill, which is explicitly prohibited from qualifying for the new deduction as tips must be voluntary.

Citizenship and [marital status](#) will also affect taxpayers’ desire and ability to cash in on “no tax on tips.” By law, taxpayers must have a Social Security Number (SSN) to claim the deduction and must also file jointly to claim the deduction if they are married.

Once taxpayers establish that they are eligible for the deduction, they will need to understand how it will affect them. The Yale Budget Lab estimates that more than 37% of [tipped workers](#) paid no federal income tax in 2022, meaning that the deduction would likely not impact their federal income taxes at all. As noted above, workers eligible to claim the deduction may have an increased payroll tax liability if they were previously underreporting tips. On the other hand, their payroll tax liability may remain unchanged if they receive a substantial portion of tips via credit and debit card payments and accurately report other tips.

Younger tipped workers would also need to take a variety of factors into account for tax purposes. The Yale Budget Lab notes that 13% of tipped workers are teenagers. If a teenager is claimed as a [dependent](#) on his parent or guardian’s tax return, he may not be eligible for the full standard deduction, which would change his tax calculation.

Reported income can also affect eligibility for certain tax credits such as the Earned Income Tax Credit (EITC), American Opportunity Tax Credit, and the Premium Tax Credit (PTC). In addition, it can affect eligibility for government assistance programs. Since the deduction is available to households earning up to \$300,000, those with higher incomes may have less to lose by reporting tip income for purposes of the deduction.

## Conclusion

Tipped workers should proceed with caution when considering tax changes under OBBBA. The IRS is taking a commendable approach by issuing clear and [early guidance](#) with a public hearing scheduled to take place on October 23. Taxpayers should still seek clarity from their employer before assuming that the new deduction will result in a huge increase to their after-tax income.

Nonetheless, it is important for all tipped workers, especially those who may have underreported tip income previously, to accurately report all tipped income. While “no tax on tips” may result in reduced tax liability for a small subset of taxpayers, concerns about misrepresenting tip income are likely overblown given that the deduction is not as much of a straight-forward tax reduction as it seems. Given that this policy is temporary until 2028, the IRS should begin collecting data as soon as possible to fully understand the impact of the deduction.

Should lawmakers seek to change the policy upon review, NTU’s [Brandon Arnold](#) has a suggestion. Implementing a \$1,000 deduction for any worker eligible to receive tips or overtime would reduce the deduction’s administrative burden for both taxpayers and the IRS while reducing workers’ taxes at a lower cost to the federal government.



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