No Tax on Tips Act: How Taxpayers Can Prepare

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Tipping has been part of the modern-day American restaurant experience for decades. Like most forms of income, these tips are taxable and subject to income tax. But what if this income was free from income tax liability?

This idea was proposed under the recently introduced bicameral legislation dubbed the No Tax on Tips Act ("Act"). This newly proposed regime has also seen traction and support at the state level. Wisconsin legislatures have proposed a similar bill to provide relief for state taxes on tipped wages. On both fronts, a closer look at the long-term economic ramifications and administrative hurdles creates cause for concern surrounding this tax policy.

Potential Complications

Potential complications with the Act lie largely with how it would be implemented. The Act creates potential impact on other tax regimes—for example, payroll taxes. While the deduction may be available for income taxes, employees and employers will still be subject to payroll taxes.

Employers will have to meticulously monitor their books and payroll. They will also have to be mindful of the deductions taken for payroll so that they align with the employees' reported income. While the employer may want to take full advantage of the wages paid deduction, an employee may feel more inclined to report more of their income as tipped income to take advantage of the deduction, creating a discrepancy if both parties are not consistent.

The Act also invites additional questions for business owners and patrons. Would businesses change how they pay their employees? Would the onus to pay tipped workers a living salary shift from business owners to restaurant goers?

Administrative Hurdles

The Act would also change reporting requirements for employees. With the introduction of this deduction of income taxes on tips, taxpayers will have additional reporting requirements to satisfy in order to take advantage of the deduction.

The IRS requires that employees keep a daily record of tips earned, report tips to their employer, and report all tips on their individual income tax return. Taxpayers who may not have been diligent with their record-keeping will now have to accurately record their tips to utilize the deduction. In addition, taxpayers will have to complete an additional tax form, Form 4137, Social Security and Medicare Tax on Unpaid Income, to accurately report their earnings.

Opposition to the Bill

The primary points of opposition for the bill relate to its ability to provide effective relief to tipped workers and cost. Studies have shown that the proposed bill would only impact a small portion of tipped workers. Tipped workers typically do not have a federal tax burden, meaning most of the workforce would remain unimpacted.

The second point emphasized the overall cost of the bill. If tips were to become untaxed, studies estimate that over a 10-year period, over $100 billion in revenue could be lost. Although tipped wages are not fully reported each year, the income that is reported and taxed makes up a substantial amount of revenue for the government. This would create a substantial gap for the government that would need to be remedied from another source of income, likely increasing the taxes for other forms of income.

How Can Taxpayers Prepare?

Even with so much uncertainty, there are steps taxpayers who may be impacted can take to prepare for the possible change.

1. **Improved record keeping.** Taxpayers on the employee side who may want to rely on the deduction should begin to implement a routine or system to record their tips daily. This will ensure that when it is time to file their tax return, they can fully account for their income for purposes of taking the deduction. In addition to the above points concerning daily record keeping, proper administrative frameworks will become of utmost importance.
2. **Discuss reporting.** Employers and employees should discuss how their income will be reported to ensure that both sides reflect accurate amounts that are consistent with each other.
3. **Monitor the books.** Employers should take steps to ensure their accounting and books are current and closely monitored.
4. **Seek counsel.** Businesses and individuals can benefit from working with a seasoned tax attorney to understand tax implications of the Act and navigate administrative hurdles.