

Employer Guide: No Tax on Tips

Step-by-step compliance for salons, barbershops, and spas (2025–2028)

READ FIRST

The deduction is claimed by your **employees** on their personal returns. Your job as the employer is to report tips correctly, capture the right occupation codes, and claim the expanded FICA Tip Credit you now qualify for as a beauty-service business. **Tips are still subject to FICA** — only federal income tax is deductible for the employee.

STEP 1

Confirm Your Workers Are in Qualifying Occupations

The deduction is occupation-based, not industry-based. The IRS publishes a closed list of qualifying occupations, each tagged with a three-digit Treasury Tipped Occupation Code (TTOC).

Common codes for our industry:

- Hairdressers / Hairstylists / Cosmetologists
- Barbers
- Shampooers
- Manicurists / Pedicurists / Nail Technicians
- Skincare Specialists / Estheticians
- Massage Therapists

Assign a TTOC to each W-2 employee now so payroll has it ready for year-end reporting. Independent contractors (booth renters) do not get a W-2 from you — they claim the deduction themselves using their own records.

STEP 2

Audit Your POS for Mandatory Service Charges

Only **voluntary** tips qualify. If your POS or booking system auto-adds a service charge, gratuity, or fee that the client cannot remove or modify, that money is **not** a qualified tip — even if you distribute it to staff.

Action items:

- Make sure the tip prompt offers a zero-tip option.
- Re-label any 'service fee' that's actually a tip as a tip.
- If you keep an automatic gratuity for groups, document it separately from voluntary tips.

STEP 3

Set Up Tip Tracking and Monthly Reporting

Employees must report tips to you by the 10th of the month following the month they were earned. Tips of \$20 or more per month must be reported in writing.

Recommended setup:

- POS captures all card/electronic tips automatically.
- Each employee logs cash tips daily in a simple form (paper, spreadsheet, or app).
- A standard Monthly Tip Report form is submitted by the 10th of the following month.
- Keep signed monthly reports on file for at least 4 years (3 IRS minimum + buffer).

STEP 4

Withhold and Remit Payroll Taxes on All Tips

Despite the name, 'No Tax on Tips' does **not** change payroll tax treatment. You must continue to withhold and remit:

- Social Security tax — 6.2% employee + 6.2% employer on wages and tips
- Medicare tax — 1.45% employee + 1.45% employer
- Federal income tax withholding on reported tips (employee may adjust W-4)
- FUTA and applicable SUTA

The deduction only affects the employee's federal income tax liability when they file their personal Form 1040.

STEP 5

Claim the Expanded FICA Tip Credit (Form 8846)

This is the real employer-side benefit. The 2025 reconciliation law **permanently expanded** the Section 45B FICA Tip Credit to beauty service businesses, including barbering, hair care, nail care, esthetics, and body and spa treatments.

What changed for you:

- Previously: only food and beverage businesses qualified.
- Now: beauty service businesses where tipping is customary also qualify.
- The credit covers the employer's 7.65% FICA on tips above the amount needed to bring the employee up to the applicable minimum wage for the month.

How to claim:

- Complete **Form 8846** (Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips).
- Attach it to your business federal income tax return (Form 1120, 1120-S, 1065, or Schedule C, depending on entity).
- Carries forward via Form 3800 (General Business Credit) if you can't use it all in the current year.

DON'T MISS THIS

If you've never claimed Form 8846 before because your salon wasn't eligible, this is new money on the table. Talk to your tax preparer about it before your business return is filed.

STEP 6

Report Tips Correctly on the 2025 W-2

For the 2025 tax year (W-2s issued January 2026), the IRS provided transition relief. Employers are **encouraged but not required** to separately break out qualified tips on the W-2.

On each W-2 for tipped employees:

- **Box 1** — Wages, tips, other compensation (includes all reported tips)
- **Box 3 / Box 5** — Social Security and Medicare wages (includes tips up to applicable caps)
- **Box 7** — Social Security tips (the reported tip amount)
- **Box 14** — Optional but strongly recommended: separately state the qualified tip amount so the employee can claim the deduction without recalculating from logs

Providing the Box 14 breakout for 2025 is the single most valuable thing you can do for your staff this filing season. Without it, they have to reconstruct qualified tips from their own records.

STEP 7**Prepare for the 2026 W-2 Requirements (Mandatory)**

Starting with wages paid in 2026 (W-2s issued January 2027), separate reporting becomes mandatory.

Required new fields:

- **Box 12, code 'TP'** — Qualified tip amount for the employee
- **Box 14b** — Three-digit Treasury Tipped Occupation Code (TTOC)

Action items before year-end 2026:

- Confirm your payroll provider supports the new Box 12 'TP' code and Box 14b TTOC field.
- Assign and document each tipped employee's TTOC in your payroll system.
- Build a process to separate qualified tips from any non-qualifying service charges.
- Train staff on the new tip reporting workflow.

STEP 8**Watch for Owner-Operator and Booth-Renter Issues**

The IRS treats tips received by an owner with caution to prevent reclassification of wages as tips.

Key rules:

- If you (the owner) cut hair and receive tips, the IRS applies an 'irrebuttable presumption' that those tips are recharacterized as wages when the recipient has a direct ownership interest in the payor.
- Booth renters are typically 1099 independent contractors. They claim the deduction on their own return using their own records — you don't issue them a W-2.
- Mixed setups (some W-2 stylists, some booth renters) require careful documentation of who is what.

If you're a solo owner-operator or have any ownership/employment overlap, consult a CPA before claiming the deduction on your own tips.

STEP 9**Recordkeeping and Audit Defense****Keep the following for at least 4 years:**

- Signed monthly tip reports from each employee

- Payroll registers showing tips, wages, withholding
- Form 941 quarterly filings
- Form 8846 worksheets and supporting calculations
- W-2s and W-3 transmittal
- POS reports separating tips from service charges

Tip reporting is a known IRS audit focus area. Clean records protect both the salon and the staff.

STEP 10

Educate Your Staff and Coordinate at Tax Time

Give every tipped employee a one-page handout covering:

- How they report tips to you (daily log + monthly form by the 10th)
- That FICA still applies — they will still see Social Security and Medicare withheld
- Their occupation qualifies and what TTOC code applies
- How to claim the deduction on Schedule 1-A when they file
- That the deduction is capped at \$25,000 and phases out above \$150,000 MAGI (\$300,000 joint)
- That state income tax treatment varies — they may still owe state tax on tips

FORM CHEAT SHEET

Quick reference — the forms you'll touch:

- Form 941 — quarterly payroll tax (no change in process)
- Form W-2 — annual wage statement (Box 14 optional for 2025; Box 12 'TP' and Box 14b TTOC mandatory for 2026)
- Form 8846 — FICA Tip Credit (newly available to beauty businesses; attach to business return)
- Form 3800 — General Business Credit (if FICA tip credit exceeds current-year liability)
- Form 8027 — Annual tip income reporting (only required if you have 10+ tipped employees on a typical day; most small salons are exempt)

This guide reflects federal rules under the One Big Beautiful Bill Act and final IRS regulations issued April 2026. State income tax treatment of tips varies by state. The deduction is currently scheduled to expire after tax year 2028 unless Congress extends it. This document is informational and not a substitute for advice from a CPA or tax attorney familiar with your specific business.