Federal Insurance Contributions Act (FICA) Tip Credit

Tax Treatment of Tip Income

Employee tip income is treated as employer-provided wages subject to income tax and employment taxes under the Federal Insurance Contributions Act (FICA). Employment taxes under FICA, or the FICA taxes, include Social Security and Medicare taxes. Employees who receive tips of $20 or more in a calendar month are required to report the amount of tips to their employers in the following month. Employers are responsible for withholding employee income tax and the employee's share of FICA taxes and paying the employer's share of FICA taxes on the reported tips.

How the Credit Works

An eligible employer may claim a credit against the business's income taxes for FICA taxes paid on certain tip wages. If an employee's non-tip wages exceed $5.15 per hour, the FICA tip credit equals the full amount of the employer's share of FICA taxes paid on the employee's tip wages. If an employee's non-tip wages are less than $5.15 per hour, the credit equals the employer's share of FICA taxes paid on the employee's hourly tip wages after reducing that tip wage by the difference between the employee's non-tip hourly wage and $5.15. The credit is available only with respect to FICA taxes paid on tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption, provided that the tipping of employees delivering or serving food or beverages by customers is customary.

The credit is non-refundable and is subject to the carryback and carryforward provisions for general business tax credits. The credit is available whether or not the employee reports on his or her own tax return the tips on which the employer FICA taxes are paid. Employers cannot deduct from taxable income the amount of FICA taxes taken into account in determining the credit, and may elect not to have the credit apply for a taxable year.

Why the Credit is a Tax Expenditure

Under a comprehensive income tax, businesses may deduct FICA taxes paid from taxable income because such taxes are a legitimate business expense. However, targeted tax credits generally are not part of a comprehensive tax system. Consequently, this credit is considered a tax expenditure because it is an exception to the provisions of a comprehensive income tax that serve as the baseline against which tax expenditures are judged. The credit results in a reduction in tax liability below the level implied by the baseline tax system.

History, Rationale and Criticism

Prior to 1966, tips were subject to individual income tax but not FICA taxes. In 1965, Congress amended the law to require employees who received cash tips of $20 or more in a calendar month after 1965 to report the tips to employers, and require employers to treat the reported tips as wages for purposes of withholding income tax and the employee's portion of FICA taxes. Employers, however, did not have to pay the employer's portion of FICA taxes on the reported tips. Tips less than $20 in a month or not paid in cash, while not being subject to withholding, continued to represent compensation for income tax purposes. A law change in 1977 required employers to pay the employer share of FICA taxes on the employee's tips, but only on amounts up to the federal minimum wage. This ceiling was removed in 1987, and consequently employers were required to pay the employer's portion of FICA taxes on all tip wages. The FICA tip credit was enacted in 1993.

Employers in the food and beverage industry maintain that the credit helps defray the administrative costs associated with complying with tip tax law, a cost occurring only in industries where tipping is customary. Supporters of the credit argue that, by offsetting employers' FICA taxes on reported tips, the credit provides an incentive for eligible employers to report tip income, thereby improving employer and employee income and employment tax compliance. They also argue that the credit helps ensure future Social Security benefits for tipped workers.

Opponents of this credit assert that, despite the credit, the underreporting tax gap on tip income remains large in the food and beverage industry. They also argue that the credit is unfair because it is available only to certain employers in the food and beverage service sectors and not available to employers in other industries. Furthermore, the favorable tax treatment on tips relative to other cash compensation unduly encourages employers to provide income in the form of tips instead of wages. The Administration has proposed to repeal the credit since its FY2016 Budget.

The Size of the Tax Expenditure

The Office of Tax Analysis estimates that, for tax year 2012, C corporations used $0.5 billion in non-refundable FICA tip credits and individual taxpayers used $0.6 billion. The associated tax expenditure, that is, the value of the credit in excess of the deduction that would otherwise have been allowed under the baseline tax, is estimated to be $1.05 billion for FY2017. This estimate of tax expenditure does not incorporate changes in taxpayer behavior that may result if the credit is repealed, such as a reduction in tip reporting. Taking into account behavioral changes, the Office of Tax Analysis estimates that repealing the FICA tip credit would increase federal receipts by $0.73 billion for FY2017.

Tentative Credits by Firm Size and Type

As background, the table below contains estimates of the tentative FICA tip credit by firm size (measured by total income) and entity type. Tentative credits are credits before limitations. This table focuses on tentative credits attributable to the business's own activity in 2012, so it excludes credits passed through from other businesses (e.g., from a partnership to a C corporation) and excludes carryforward and carryback amounts. For tax year 2012, about 8,100 C corporations, 36,600 S corporations, 16,950 partnerships and 4,750 sole proprietorships reported tentative credits for the FICA taxes they paid on employee tips during the tax year. In aggregate, C corporations generated about $0.5 billion in credits and pass-through businesses generated nearly $0.8 billion. These amounts differ from the estimates of credits actually used (given above) because of transfers of credits across firms and restrictions on credit use imposed by nonrefundability. The amount of tentative credits was concentrated among C corporations with incomes above $100 million and pass-through entities (including S corporations and partnerships) collecting between $1 million to $10 million of income.

Table 1: Aggregate Tentative FICA Tip Credits by Firm Size and Type (Tax Year 2012)

	C Corporations		S Corporations		Partnerships		Sole Proprietorships	
	Number of firms	Thousands ($)	Number of firms	Thousands ($)	Number of firms	Thousands ($)	Number of firms	Thousands ($)
Total Income								
< $1 million	5,500	20,500	19,950	54,200	5,300	19,200	3,250	10,700
$1 million-$10 million	2,250	45,700	16,050	234,900	10,850	225,100	1,450	17,900
$10 million-$25 million	100	12,800	400	38,000	400	32,200	50	3,600
$25 million-$100 million	100	37,400	150	27,600	300	60,700	*	*
$100 million-$1 billion	100	166,700	50	18,600	100	52,200	*	*
> $1 billion	50	238,700	*	*	*	*	*	*
Total	8,100	521,800	36,600	373,300	16,950	389,400	4,750	32,200

* Fewer than 25 firms.