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No Tax on Tips! What President Trump's Promise May Mean for Your Business

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If you're a political nerd like me, you may have observed then-candidate and now President Donald J. Trump's pledge to eliminate taxes on tips. In fact, he doubled down on this promise in his speech to Congress on March 4, 2025, stating, "For any worker who relies on tipped income, your tips will be 100% yours." This statement comes at a time when many restaurants are pivoting to a service fee system. You know that controversial 15-25% fee that is often disclosed at the bottom of your menu and shows up on your bill?

While the service fees may anger some (see countless social media posts raging against service fees), they serve an important purpose for many restaurants, including helping to provide healthcare for employees and lowering the disparity in pay between front and back-of-house workers. The National Restaurant Association estimates that 15% of all restaurants now collect service fees.[1] While customers may perceive these service fees as another way to provide tips to service staff, business owners should beware as the distinction between the two has important tax and compliance implications. Between Federal Insurance Contributions Act (FICA) tax liabilities, service fee classifications, and U.S. Internal Revenue Service (IRL) and U.S. Department of Labor (DOL) compliance, getting this wrong can mean lost profits, legal problems, and surprise tax bills - and when your margins are slim, these can make or break your business. But before we dive into the legalese, let's look at the history of tips in the restaurant industry and the evolving regulatory landscape surrounding service fees.

A History Lesson

Tips: Many readers may have noticed in their travels abroad that tipping is not expected in European countries. Surprisingly, that wasn't always the case. In fact, tipping was a widely used practice in Europe beginning in the Middle Ages, when wealthy individuals tipped their servants for a job well done. American travelers took note of the practice and brought it back to the United States. Many American diners were steadfastly against the tipping system, so much so that the anti-tip fervor sweeping the U.S. spread to Europe, where it eventually fell out of favor.[2] Following the Civil War, many businesses in the U.S. used tipping as a way to take advantage of workers, especially freed slaves, perpetuating this abhorrent practice. The issue remained controversial for several years, with many states attempting to abolish the practice. Still, the signing of the Fair Labor Standards Act of 1938 (FLSA) and its subsequent amendments solidified the practice.

Taxes: In 1966, an amendment to the FLSA was passed, codifying the practice of tip credits into law by allowing employers to count tips received by "tipped employees" toward up to 50% of the minimum wage. This percentage remained unchanged until 1977, when the FLSA was amended, reducing the tip credit to 40%. In 1991, it was reduced again, but this time on a dollar basis, to $2.13 per hour, or about 29%, where it remains today. Prior to the 1993 Small Business Job

Protection Act (SBJPA), employers also had to contend with deducting FICA taxes from reported tips. The SBJPA changed this, allowing employers to claim a tax credit for the FICA taxes paid on tips that exceed the federal minimum wage and decoupling the tipped employee wages from the federal minimum wage. The IRS uses a four-factor test to determine whether a payment qualifies as a tip: (1) The customer makes the payment free from compulsion; (2) The customer must have the unrestricted right to determine the amount; (3) The payment should not be the subject of negotiations or dictated by employer policy; and (4) Generally, the customer has the right to determine who receives the payment.[3]

This disparity between “tipped employees” and “non-tipped employees” has engendered much debate since, with many advocacy organizations calling for the application of the full minimum wage to restaurant employees, and some industry groups pushing back. Several states have enacted legislation to eliminate the subminimum wage at the state level for tipped employees, including Alaska, California, Minnesota, Montana, Nevada, Oregon, and Washington, as well as cities like Washington, D.C., and Chicago. The debate over the compensation of tipped employees reached a fever pitch during the COVID-19 pandemic, with many bars and restaurants, and their employees, out of work and searching for ways to close the revenue gap from lost diners. Enter service fees.

Service Fees: Junk Fees or Something Else? The Federal Trade Commission (FTC), then under the auspices of the Biden Administration, initiated the rulemaking process to address "junk fees" by issuing an Advance Notice of Proposed Rulemaking (ANPR) on November 8, 2022. The Notice of Proposed Rulemaking was issued one year later, kicking off the notice and comment period across a broad range of industries. The rule was intended to provide pricing transparency for consumers, requiring businesses, including restaurants, “to quote total prices at the start of the purchasing process and to remove false or misleading information about fees from the marketplace.”[4] If enacted in its original form, this rule would have banned services fees; however, thousands of restaurant owners and operators were mobilized due to a successful lobbying campaign organized by the Independent Restaurant Coalition, the National Restaurant Association, and others.[5] Those owners and groups countered the FTC’s position, arguing that service and delivery fees are standard practices necessary for operational viability and should not be categorized as deceptive "junk fees." Acknowledging the concerns expressed by the restaurant owners, the FTC ultimately decided to exclude restaurants from the final rule.

Tax Implications of Tips v. Service Fees*:* Because tips are provided directly to employees, they are considered employee income, requiring employees to report and pay taxes on them. Employers must also withhold FICA taxes on reported tips. As noted above, however, employers benefit from the FICA Tip Credit, allowing them to receive a credit for the employer portion of the payroll taxes paid on tips that exceed the minimum wage. For high- volume bars and restaurants, this can mean thousands of dollars in tax savings per year. Service fees, unlike tips, are considered employer-controlled wages. Since they are imposed by the employer rather than given voluntarily by the customer, the IRS categorizes them as standard wages. As a result, employers must factor them into overtime calculations, withhold payroll taxes, and report them as part of an employee’s earnings. Unlike tips, service fees are not eligible for the FICA Tip Credit, meaning employers are responsible for paying 100% of the payroll taxes on these fees. Interestingly, the Restaurant Service Charge Fairness Act, introduced in 2024 by Representative Earl Blumenauer, seeks to (i) exclude service fees from FICA taxes, aligning them with traditional tips; (ii) impose a 25% cap on the

aforementioned exclusion; (iii) require that employers choose between the service fee credit or the traditional tip credit, but prohibits claiming both; (iv) mandate that service fees be directly distributed to non-management employees as wages; and (v) exclude service fees from overtime calculations, preventing double taxation.[6]

Compliance Obligations: The distinction between tips and service fees also has important compliance implications. For instance, if an employer were to improperly categorize a service fee as a "tip" on payroll records, it could face IRS penalties for misclassification. The Department of Labor (DOL) enforces strict guidelines regarding the handling of service fees. While employers have discretion over these funds, any portion given to employees must be treated as regular wages, meaning they must be accounted for in overtime calculations and included in payroll for tax purposes. It is, therefore, very important that employers exercise caution when creating wage structures. Employers should also be aware that some states have disclosure laws related to service fees. This means businesses that rely on service fees must be careful that the fees are being disclosed in compliance with applicable state wage and hour law or face possible enforcement action at the state and/or local level. Relatedly, since state and local laws on service fees vary, businesses must stay up-to-date in real-time on new and changing laws. By way of example, Minnesota passed a law prohibiting service fees entirely, and Illinois legislators are currently considering transparency requirements for service fees.[7] [8]

How Would Eliminating Taxes on Tips Affect the Industry: While the President's proposal seems to focus on eliminating federal income tax on tips for employees, it remains unclear whether FICA taxes would also be exempted. If FICA taxes on tips were abolished, employers would no longer be obligated to withhold these taxes or pay the matching portion, effectively nullifying the need for the FICA Tip Credit and simplifying the payroll process. Such a move would be a financial boon to struggling bars and restaurants and may eliminate the need for service fees altogether. However, it may also disadvantage establishments that have transitioned to a service fee model, as servers might be drawn to businesses that offer traditional tipping. Additionally, the resulting loss of revenue for the U.S. government could significantly impact Social Security and Medicare funding-programs the President has pledged to protect.

At Benesch, we will be monitoring future legislative updates related to this issue closely. If you have additional questions or are seeking representation for your restaurant or bar, please contact Richard Cole Eastman.

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[1] Struett, David. "Chicago Restaurants Still Add Pandemic-Spurred Surcharges to Your Bill." *Chicago Sun-Times*, 31 Oct. 2023, chicago.suntimes.com/2023/10/31/23890882/restaurant-surcharges-service-fees-credit-card-minimum-wag Accessed 20 Mar. 2025.

[2] Greenspan, Rachel E. "It's the Legacy of Slavery": Here's the Troubling History behind Tipping Practices in the U.S." Time, 15 Oct. 2018, time.com/5404475/history-tipping-american-restaurants-civil-war/

[3] See Tip income is taxable and must be reported | Internal Revenue Service

[4] See FTC Proposes Rule to Ban Junk Fees | Federal Trade Commission

[5] Romeo, Peter. “Restaurants Dodge a Bullet on Service Fees.” *Restaurant Business*, 17 Dec. 2024, www.restaurantbusinessonline.com/financing/restaurants-dodge-bullet-service-fees. Accessed 20 Mar. 2025.

[6] See House Bill 8401

[7] Jackson, Sharyn, and Sharyn Jackson. “Restaurant Service Charges Will Disappear, but Don’t Call Them “Junk Fees.”” Startribune.com, 30 Dec. 2024, www.startribune.com/restaurant-tipping-service-fee-ban-minnesota-law/601200465. Accessed 20 Mar. 2025.

[8] See Illinois House Bill 0062 and Senate Amendment 1 to Senate Bill 1486