DAILY COVER

Taxing Tips: Untangling The Hairy Situation Between Beauty Salons, Restaurants And The IRS.

ILLUSTRATION BY PHILIP SMITH FOR FORBES

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Congress created a big incentive for restaurants and bars to report employees' tips, which can be good for workers, too—even if many don't believe it. So why hasn't it done the same for the largely female-owned beauty industry?

By Kelly Phillips Erb, Forbes Staff

The holidays are coming and Paige Garland, co-owner of Rachel's Salon and Day Spa in downtown Memphis, is bracing for a tax hit. Along with springing for more of the salon's $72 event up-dos and $94 highlights, customers will also be giving moregenerous-than-usual tips to their favorite stylists. As a matter of salon policy, those holiday tips will be rung up separately on Rachel's payment processing system with 100% going to the employee and all of it properly reported as income to the Internal Revenue Service on the stylists' W-2 forms.

The problem for Garland is this: for every $100 in tips an employee collects, Rachel's owes the IRS $7.65 as the employer's share of Social Security and Medicare payroll taxes—even though not a penny of that $100 tip goes to the salon, and even though under reporting of tips is widespread in the industry.

Paige Garland, co-owner of Rachel's Salon and Day Spa in downtown Memphis COURTESY OF PAIGE GARLAND

If that sounds unfair to an honest salon owner like Garland, get this: If Rachel's were a restaurant serving cactus, instead of a salon and day spa that serves up $132 cactus fruit hydrating facials, the government would give it a tax credit to offset the full employer's share of payroll taxes. "Welcome to the salon industry," she says.

The tax problem—and the disparity with restaurants—has been around for decades. But the issue has gained new urgency for salon owners like Garland due to the lingering impact of the pandemic and the fintech-enabled, Covid-hastened shift from cash to credit cards and payment apps. Electronic payments make it trickier for salons or workers to grossly under report tips and assume they'll get away with it forever.

Some salons that don't want to get stuck with the tax bill treat all those cutting hair, doing nails, or giving facials as 1099 independent contractors for tax purposes (even if legally they probably don't qualify as such). As contractors, the workers are responsible for reporting their own tips honestly (not so likely) and paying both the employee and employer's share of Social Security and Medicare —a total of 15.3%.

Garland, a University of Memphis grad who began her career in the business side of the cosmetics industry (she still does special occasion makeup), admits that treating all the workers as W-2 employees was a tough sell when she first opened her business in 2014. Her pitch to potential employees: you can't get a mortgage or a car loan or even qualify to rent an apartment if your full income doesn't show up on your tax return.

Before Covid, Rachel's Salon and Day Spa had grown to 13 employees, each with brimming client books of business. With many still working remotely, her downtown location hasn’t rebounded completely—the operation is back up to just six employees, only two of them holdovers from her pre-Covid days. Customers no longer carry cash, she notes, and sometimes want to tip workers via payment app Venmo. Garland has to remind those customers to "please tip on your card," explaining why it's important for salon workers to document proof of income. “Paying in cash is not an alternative,” she says.

[Congress recently asked third party platforms like Venmo to step up their reporting to the IRS. The new requirement will likely begin in 2024.]

Outside of the nation’s 2.2 million waiters and waitresses, the nearly 1.2 million American workers who provide hair and nail care, skin, spa and massage treatments receive more tips than any other group. And the beauty workers are gaining ground on restaurant workers. According to the Bureau of Labor Statistics the number of waiters will shrink 3% over the next decade, while employment will grow 8% in hair care, 9% in skin care, 9% for manicurists and 18% for massage therapy, provided in both spas and medical settings.

A combination of reporting holes and varying tipping behavior–it can change depending on where you live and the nature of services–means that it’s difficult to find reliable data on tips. A detailed Economic Policy Institute study from 2016 estimated that all workers earned $36.4 billion in tips–around $28 billion of that estimate is attributable to full-service restaurants. The remaining $8 billion or so is earned by tipped workers outside of the restaurant industry, including salon workers.

> **"People think that people who don't report (tip) income are just dishonest. But a lot of time they're just confused."**

According to a survey by fintechs Tippy and Branch, 65% of salon and spa workers rely on tips for at least a quarter of their income, while 20% get half or more of their earnings from tips. These aren't generally high-income folks; BLS reports median earnings in 2022 ranged from $31,130 for manicurists to $33,400 for barbers and hair stylists to $38,000 for skin care specialists to almost $50,000 for massage therapists. (Those numbers are likely understated, due to underreporting of tips.) Still, at these modest income levels, workers generally owe more in Social Security and Medicare taxes than in federal income tax. So there's a real benefit for them to be considered employees, with the bosses picking up half the 15.3% payroll tax tab. Sure, the bosses might make them report more (or even all) of their tips, but that earns them a bigger Social Security benefit down the line.

Until 1966, tips weren't subject to payroll taxes—also known as Federal Insurance Contributions Act (FICA) taxes. That year, with the creation of Medicare, Congress changed the law to impose FICA taxes on tips, but just on the employee's side. It added some employer FICA taxes on tips in 1977 and in 1987 required employers to kick in FICA taxes on all tips. Restaurants and bars screamed bloody murder and started a lobbying push. They won a partial FICA tip credit in 1993 and what's known as the 45B credit has since been expanded to rebate the entire employer side of FICA taxes on tips. The instructions for claiming the 45B credit make clear it's only to cover tips to employers involved in "providing, delivering, or serving food or beverages for consumption."

The justification for the credit is that it's a matter of fairness for restaurants (assuming they're not keeping a cut of tips) and gives them an incentive to honestly report employees' tip income to the IRS. In its latest Tax Gap study, the IRS estimates that it gets 99% of what it's due on regular wages, where taxes are withheld and reported to both the IRS and the taxpayer on a W-2, but just 55% of what it's owed on tips (the same percentage it figures it collects from self-employed sole proprietors).

In fact, the IRS is so keen to get help on tip reporting from employers, that it's pushing a new service industry compliance initiative designed to simplify compliance for outlets that rely on a point-of-sales system and accept electronic payments for tips. The employer would calculate (and report to the IRS on a W-2) each worker's minimum tips by including all electronically paid tips and an estimate of cash tips on other sales. (The IRS concedes cash tips should be estimated at a lower average rate and that a "stiffing" discount must be applied, for those who don't tip at all.)

Not all salon owners are on board with reporting tips. Some would just as soon look the other way and hope the understaffed IRS doesn't come calling.

But a tax audit could be devastating for a salon, warns Maggie DiFalco, who owns two locations of Maggie The Salon, in Plantation and Pembroke Pines, Florida. DiFalco says that 90% of her business, including tips, is now conducted on credit or debit cards, and the salon aims to be totally paperless—they text or email receipts. That's efficient, and customers like it, but it leaves a clear digital trail. She reports stylist tips and pays the tax. "I don't want to go to federal prison, so this is what we do."

Maggie DiFalco, of Maggie The Salon (right) with her daughter, Jaclyn Gonzalez PATTY DANIELS

DiFalco has been a salon owner for 29 years–and it isn't her first job. Her college degree was in elementary education, but after the birth of her second child, she wanted more time at home. She started selling clothes, first from her garage and eventually in a separate space inside a salon. When the salon owner lost her lease, DiFalco jumped in and opened a new salon in the space. She was told that she wouldn't be able to succeed since she had no background in hair. But, "business is business," says DiFalco, sounding tired after a long day at work. Today, she owns two salons, manages 34 employees and has consistently seen her business named one of the top 200 salons in North America by *Salon Today*.

The industry has changed a great deal since the days when DiFalco's daughter, Jaclyn Gonzalez, then age 11, used to come to the salon to wash hair. Now 40, Gonzalez, a licensed stylist and cosmetologist, is hoping to take over the business. In the meantime, not a day passes that DiFalco doesn’t worry about the future. A tip credit, she says, would allow salon owners like her to put more money back into the business, including for recruitment and education–leading to more and better paying jobs for workers.

DiFalco, who now sits on the board of the salon-owner trade group, the Professional Beauty Association, has been lobbying for House and Senate bills that would extend the full 45B credit to salons and spas. (Appropriately, they’re labeled H.R. 45 and S. 45.) Versions of the bill currently have 36 co-sponsors in the House and four co-sponsors in the Senate—and support is bipartisan.

As both industry lobbyists and bill sponsors point out, the predominantly woman owned industry, with a high percentage of both minority ownership and employment, simply isn’t being treated equally with the restaurant business. "The playing field is not level," says Kati Rapoza, the Government Affairs Manager at the PBA. She concedes the bill is only likely to find its way into law as part of a bigger tax package, but it presumably won’t cost the government much, with the credit being offset by improved compliance.

Frank Zona speaking to staff at his salon in Southeastern Massachusetts. COURTESY OF FRANK ZONA

"People think that people who don't report (tip) income are just dishonest. But a lot of time they're just confused,'' says Frank Zona, a stylist who owns two beauty parlors and a barber shop in southeastern Massachusetts and is also backing H.R. 45. He's a third-generation salon owner—- his immigrant grandfather owned a shop in Sicily and then in the Bay State. Zona treats all 41 of his workers (down from his pre-Covid roster of 70 workers) as employees though he is no fan of too much government. Several years ago he pushed for the loosening of cosmetology licensing requirements for those who want to take entry level jobs in salons. But Zona figures a 45B credit would give more salons an incentive to put people on the books, while allowing them to reinvest in their businesses and employees—including by providing financial literacy tools. The lack of a verifiable financial history in the form of a W-2 can exacerbate existing gender and racial savings gaps, he argues.

It's a pattern that's familiar to David Tashjian, CEO of Tippy, a start-up that offers a stand-alone kiosk which allows customers to tip with a card at the counter. His mother-in-law spent her career as a stylist and educator at a salon in Pennsylvania, Lords & Ladies, where his brother-in-law later worked and came up with the idea for Tippy. Tashjian, a former Lazard managing partner (he specialized in distressed debt) turned tech entrepreneur, already had experience in the payments industry, so they built the platform together.

One of the investors in the new private venture? An owner of seven Pennsylvania salons who gave Tippy access to his 226 stylists to try out different variations. Tippy was literally designed and built "in-industry," before formally launching in 2019, Tashjian says. Even pre-Covid, customers liked the credit card option, but it was a struggle to convince stylists to move from cash to plastic—until they learned what studies and experience during Covid have shown: credit card tips tend to be bigger than cash tips.

Last year, Tippy partnered with payments platform Branch to allow salon employees to quickly cash out tips using the Branch debit card, Apple Pay, Google Pay, or by transferring the tips to another account they have. In a recent survey by Tippy and Branch, 48% of beauty and wellness workers indicated they are more likely to save their digital tips than cash tips, but 82% still liked having immediate access to digital tips, saying it made them feel more financially secure.

Even if the workers are sold, Tashjian admits he's still having trouble convincing some salon owners who don't want to create an electronic trail that would help the IRS to hold them accountable for the employer share of the payroll tax. They tell him,"`As soon as you get the (45B) credit, call me.'"

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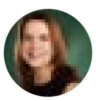

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