

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Donnelly Analyst: Scott McFarlane Bill Number: AB 2080

Related Bills: None Telephone: 845-6075 Introduced Date: February 20, 2014

Attorney: Bruce Langston Sponsor: _____

SUBJECT: Exclude Tips from Gross Income

SUMMARY

This bill would:

- Under the Personal Income Tax Law, treat tips as gifts that would be excluded from gross income;
- Under the Administration of Franchise and Income Tax Laws, exclude tips from supplemental wages subject to withholding for purposes of the wage withholding tables that are prepared annually by the Franchise Tax Board (FTB); and
- Under the Unemployment Insurance Code, exclude tips for unemployment purposes.

This analysis only addresses the provisions of the bill that would impact the department's programs and operations; thus, the provisions that would affect the Unemployment Insurance Code are not discussed.

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for the bill is to help struggling families keep more of the money they earn.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2015, and would be specifically operative for taxable years beginning on or after that date.

Board Position:

_____ S _____ NA X NP
_____ SA _____ O _____ NAR
_____ N _____ OUA

Executive Officer

Date

Selvi Stanislaus

04/03/14

ANALYSIS

FEDERAL LAW

Gross Income

Gross income is the starting point in determining an individual's taxable income. Gross income is broadly defined, and generally consists of all income from all sources, such as compensation for services, business income, interest, rents, dividends, and gains from the sale of property.¹ Only items that are specifically exempt may be excluded from gross income. There is no specific exemption for tips, thus they are includible in gross income.

Information Returns

In General

A variety of information reporting requirements apply under present law.² The primary provision governing information reporting by payors requires an information return by every person engaged in a trade or business who makes payments to any one payee aggregating \$600 or more in any taxable year in the course of that payor's trade or business.³ Reportable payments include compensation for both goods and services, and may include gross proceeds. Certain enumerated types of payments that are subject to other specific reporting requirements are carved out of reporting under this general rule by regulation.⁴ Another carve out is provided for tips with respect to which IRC section 6053 applies.⁵

Special Rules for Tips

IRC section 6053(a) requires any employee who, in the course of employment, receives in any calendar month cash tips of \$20 or more that are wages⁶ or that are compensation⁷ to report all such tips in one or more written statements furnished to their employer on or before the tenth day following such month.

IRC section 6053(b) requires employers, under certain circumstances, to provide an information return to report an allocation of tips in large food or beverage establishments (defined generally to include those establishments that normally employ more than ten employees). Under this

¹ IRC section 61.

² IRC sections 6031 through 6060.

³ IRC section 6041(a). Information returns are generally submitted electronically on federal Forms 1096 and federal Forms 1099, although certain payments to beneficiaries or employees may require use of federal Forms W-3 and W-2, respectively. Treas. Reg. section 1.6041-1(a)(2).

⁴ IRC section 6041(a) requires reporting of payments "other than payments to which IRC section 6042(a)(1), 6044(a)(1), 6047(c), 6049(a), or 6050N(a) applies and other than payments with respect to which a statement is required under authority of IRC section 6042(a), 6044(a)(2), or 6045." The payments thus excepted include most interest, royalties, and dividends.

⁵ IRC section 6041(e).

⁶ As defined in IRC section 3121(a) or IRC section 3401(a).

⁷ As defined in IRC section 3231(e).

provision, if tipped employees of large food or beverage establishments report tips aggregating more than eight percent of the gross receipts of the establishment, then no reporting of a tip allocation is required. However, if the eight-percent reporting threshold is not met, the employer must allocate (as tips for information reporting purposes) an amount equal to the difference between eight percent of gross receipts and the aggregate amount reported by employees.

IRC section 6051(c) imposes reporting requirements on large food or beverage establishments.⁸ An employer that is a large food or beverage establishment is required to file a separate information return for each year that it has employees. The information return is required to include the establishment's gross receipts from food or beverages (other than non-allocable receipts),⁹ the aggregate amount of charged receipts (other than non-allocable receipts), the aggregate amount of charged tips shown on such charged receipts, the aggregate amount of tips actually received by the establishment's food or beverage employees and reported to the employer under IRC section 6053, and the aggregate amount the employer is required to report under IRC section 6051 with respect to service charges of less than ten percent.

Penalties for Failure to File Correct Information Returns

As explained above, present law imposes information reporting requirements on participants in certain transactions. Under IRC section 6721, any person who is required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is \$15 per return (the "first-tier penalty"), with a maximum penalty of \$75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is \$30 per return (the "second-tier penalty"), with a maximum penalty of \$150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is \$50 per return (the "third-tier penalty") with a maximum penalty of \$250,000 per calendar year. If a failure is due to intentional disregard of a filing requirement, the minimum penalty for each failure is \$100, with no calendar-year limit.

Penalties for Failure to File Correct Payee Statements

IRC section 6722 imposes penalties for the failure to furnish correct payee statements. The penalty amount is \$50 for each failure to furnish a payee statement, up to a maximum of \$100,000. If the failure is due to intentional disregard, the amount of the penalty per failure is increased¹⁰ and the cap on the penalty is not applicable.

⁸ A food or beverage establishment is a large food or beverage establishment if it normally employed more than ten employees on a typical business day during the preceding calendar year and the tipping of food or beverage employees of the food or beverage operation is customary.

⁹ Non-allocable receipts means receipts that are allocable to carryout sales or services with respect to which a service charge of ten percent or more is added.

¹⁰ IRC section 6722(c)(1) provides that the penalty per failure is the greater of \$100 or a fixed percentage of the aggregate items to be shown on the payee statements. The fixed amount is 10 percent for statements other than those required under IRC sections 6045(b), 6041A(e), 6050H(d), 6050J(e), 6050K(b), or 6050L(c).

Taxable-Year-of-Inclusion Rules

Tips reported by an employee to his or her employer in a written statement furnished to the employer pursuant to IRC section 6053 (described above) are required to be included in the employee's gross income for the taxable year in which the written statement is furnished to the employer.¹¹

STATE LAW

Gross **Income**

California generally conforms to the federal definition of gross income, and like federal law, tips are includible in California gross income.¹²

Information Returns

In General

The FTB may generally request a copy of any information return that is required for federal purposes under IRC section 6041.¹³

Special Rules for Tips

The FTB does not generally request copies of IRC section 6053 information returns and payee statements relating to tips.

Penalties for Failure to File Correct Information Returns

The California Revenue and Taxation Code (R&TC) generally conforms to the federal penalties for the failure to file correct information returns and to the federal penalty amounts,¹⁴ but specifically does not conform to the penalties for the failure to file correct information returns required under IRC section 6053(c)(1) relating to reporting requirements of certain large food or beverage establishments.¹⁵

Penalties for Failure to File Correct Payee Statements

The R&TC generally conforms to the federal penalties for the failure to file correct payee statements,¹⁶ but specifically does not conform to the penalties for the failure to file correct payee statements required under IRC sections 6053(b) and 6053(c) relating to reporting of tips.¹⁷

¹¹ IRC section 451(c).

¹² R&TC section 17071.

¹³ R&TC section 18631.

¹⁴ R&TC section 19183(a).

¹⁵ R&TC section 19183(d)(2)(B).

¹⁶ R&TC section 19183(b).

¹⁷ R&TC section 19183(d)(3)(B).

Taxable-Year-of-Inclusion Rules

California conforms to the federal taxable-year-of-inclusion rules that apply to certain tips.¹⁸

Wage Withholding Tables

On an annual basis, the FTB is required to provide the Employment Development Department with wage withholding tables to be used by employers to withhold taxes on wages paid to their employees. The tables are based on the estimated amount of tax due on the wages paid by the employer. In addition, employers required to withhold tax on supplemental wages can use a method that applies a fixed rate to the supplemental wage amount.¹⁹

THIS BILL

This bill would exclude tips from gross income, and provide that tips would be treated as property transferred by gift. The term “tips” would include any gratuity provided by a customer or client of the employer’s business.

This bill would provide that the wage withholding tables would exclude tips from supplemental wages subject to withholding, and would make coordinating changes to exclude tips from other miscellaneous provisions that relate to wages and compensation (e.g., tips would be excluded from payments subject to information reporting and the taxable-year-of-inclusion rules).

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

This bill would define “tips” as an amount that includes any gratuity provided by a customer or client of the employer’s business. This definition is unclear about what amounts would be considered as “tips,” and the absence of a clear definition would lead to disputes between taxpayers and the department. Thus, the author may want to consider modifying the definition of “tips” to be the amount of tips that employees are required to report to their employer under IRC section 6053(a).

This bill would provide that the wage withholding tables would exclude tips from supplemental wages subject to withholding; however, for federal and state purposes, cash tips are considered wages, not supplemental wages. Thus, to achieve the intended purpose of excluding tips from the wage withholding tables, the author may want to consider modifying this bill to provide that the wage withholding tables would exclude tips from wages (as opposed to excluding tips from supplemental wages).

¹⁸ R&TC section 17551.

¹⁹ R&TC section 18663.

TECHNICAL CONSIDERATIONS

This bill would provide that tips would be treated as “property transferred by gift.” For consistency with IRC section 102(a), the reference should instead be “property acquired by gift.”

This bill would provide that the penalty under IRC section 6724(d)(1)(B)(xvi) for the failure of certain large food or beverage establishments to provide correct information returns would not apply, and that the penalty under IRC section 6724(d)(2)(X) for the failure to file correct payee statements would not apply; however, these provisions would be unnecessary as California law currently provides that such penalties do not apply.²⁰ Thus, the author may want to consider removing Section 7 from this bill.

OTHER STATES’ INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to *California’s* economy, business entity types, and tax laws. A review of these states’ laws found that *Illinois, Massachusetts, Michigan, Minnesota, and New York* all require tips to be included in gross income. *Florida* does not impose income tax on individuals.

FISCAL IMPACT

This bill would not significantly impact the department’s costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 2080, As Introduced February 20, 2014 For the Taxable Year Beginning On or After January 1, 2015 Assumed Enactment After June 30, 2014 (\$ in Millions)		
2014-15	2015-16	2016-17
- \$33	- \$60	- \$65

This estimate does not account for changes in employment, personal income, or gross state product that could result from this bill.

SUPPORT/OPPOSITION

Support: Unknown.

Opposition: Unknown.

²⁰ R&TC sections 19183(d)(2)(B) and 19183(d)(3)(B).

ARGUMENTS

Proponents: Those in support of this bill may argue that it is needed to provide tax relief to low-wage earning service workers who are struggling financially.

Opponents: Those in opposition to this bill may argue that increasing the minimum wage would be a more equitable way to provide financial assistance to low-wage earning service workers.

POLICY CONCERNS

This bill would create a difference between federal and California tax law, thereby increasing the complexity of California tax-return preparation.

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