STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: Ochoa Bogh, et al.

Sponsor:

Bill Number: SB 17

Related Bills: See Legislative History

Introduced: December 2, 2024

SUBJECT

Gross Income Exclusion - Tips

SUMMARY

Under the Personal Income Tax Law (PITL), for taxable years beginning on or after January 1, 2026, this bill would treat tips as gifts that would be excluded from gross income. Under the Administration of Franchise and Income Tax Laws (AFITL), this bill would exclude tips from supplemental wages subject to withholding for purposes of the wage withholding tables that are prepared by the Franchise Tax Board (FTB). Under the Unemployment Insurance Code (UIC), this bill would exclude tips from wages for unemployment purposes. The bill would also make changes to other related provisions.

This analysis only addresses the provisions that would impact the FTB.

RECOMMENDATION

No position—The three-member Franchise Tax Board has not formally voted or taken a position on this bill.

SUMMARY OF AMENDMENTS

Not applicable.

REASON FOR THE BILL

The reason for the bill is to help workers retain more of their earnings.

ANALYSIS

This bill would, under the PITL, provide that for taxable years beginning on or after January 1, 2026, tips received by employees would be excluded from their gross income. For purposes of the gross income exclusion, the definition of “tips” would be any gratuity provided by a customer or client of the employer’s business.

In addition, this bill would do the following:

- Provide that tips be treated as property transferred by gift, which would be excluded from gross income.
- Remove tips from an employee's deduction limitation as it relates to contributions made to an Archer Medical Savings Account.
- Not conform to the rules that require tips included in a written statement furnished to an employer by an employee, be deemed received at the time the written statement was furnished.
- Not conform to the rule that states Internal Revenue Code (IRC) section 6041, relating to information at source, reporting requirements do not apply to tips if IRC section 6053(a), relating to reporting of tips, applies.
- Modify the definition of "supplemental wages" in the AFITL, to remove tips, defined as any gratuity provided by a customer or client of the employer's business, from the wage withholding tables prepared and made available by the FTB to the Employment Development Department (EDD).

Under the AFITL, this bill would modify the indexing of the penalties for failure to file correct information returns and failure to furnish correct payee statements. It would also specify that the waiver of certain penalties based on reasonable cause would not apply to returns relating to reporting of certain tips. Under the UIC, this bill would not include tips in wages for the purpose of withholding taxes from wages.

For purposes of complying with Revenue and Taxation Code (RTC) section 41, the Legislature finds and declares the goal of the exclusion is to help struggling workers retain more of their earnings. This bill would require the FTB to provide a report including the number of taxpayers excluding tips from income and the average dollar value of the tips excluded to the Legislature no later than December 1, 2036, to the extent that data is available. The RTC section 41 reporting requirement would be treated as an exception to the general prohibition against disclosure of confidential taxpayer information and would become inoperative on December 1, 2040.

Effective/Operative Date

This bill would be effective January 1, 2026, and specifically operative for taxable years beginning on or after January 1, 2026.

Federal/State Law

Federal and state laws provide that gross income includes all income from whatever source derived, including compensation for services, gratuities received while providing services, i.e., "tips," business income, gains from property, interest, dividends, rents, and royalties, unless specifically excluded. Types of income currently excluded include amounts received as a gift or inheritance, certain compensation for injuries and sickness, educational assistance programs, foster care payments, interest received on certain state or federal obligations, and qualified scholarships. There is no specific exemption for tips, and as such, they are includible in gross income.

Federal Law

Information Returns

A variety of information reporting requirements apply under current law. 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. Reportable payments include compensation for both goods and services, and may include gross proceeds. Reporting for tips is carved out of this general rule if reporting required by IRC section 6053 applies.

Special Rules for Reporting of 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 wages or that are compensation 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.

Penalties for Failure to File Correct Information Returns

As explained above, current 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 and 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. This penalty is indexed for inflation.

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 $250 for each failure to furnish a payee statement. This penalty is indexed for inflation.

Taxable-Year-of-Inclusion Rules

Tips reported by an employee to their 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.

State Law

Special Rules for Tips

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

Penalties for Failure to File Correct Information Returns

The RTC generally conforms to the federal penalties for the failure to file correct information returns 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.

Penalties for Failure to File Correct Payee Statements

The RTC generally conforms to the federal penalties for the failure to file correct payee statements but specifically does not conform to the penalties for the failure to file correct payee statements required under IRC sections 6053(c).

Taxable-Year-of-Inclusion Rules

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

Wage Withholding Tables

On an annual basis, the FTB is required to provide the EDD 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.

Under existing state law, legislation that would create a new tax expenditure, which includes a credit, deduction, exemption, or any other tax benefit as provided for by the state, is required to include specific goals, purposes, objectives, detailed performance indicators and data collection requirements measures to allow the Legislature to evaluate the effectiveness of the tax benefit. Legislation that would create an income exclusion would not require detailed performance indicators and data collection requirements performance measures if the Legislature determines there is no available data to collect and report.

Implementation Considerations

The FTB has identified the following considerations and is available to work with the author's office to resolve these and other considerations 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 as to what amounts would be considered "tips," and the absence of a clear definition could lead to disputes between taxpayers and the FTB. 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).

Technical Considerations

To prevent chaptering issues with AB 1443 (Castillo, 2025/2026), double jointing language is needed and should be added to the bill.

In Sections 17131.18.5(c)(1)(B) and (c)(2)(A), replace "value" with "amount."

In Section 17132.6 strike out "…Section 102(a) of the Internal Revenue Code is modified to treat tips as property transferred by gift." And replace with "…Section 102(a) of the Internal Revenue Code, relating to general rule, is modified to treat tips as property acquired by gift."

In Section 18631(e) replace, "…Section 6041(e) of the Internal Revenue Code shall not apply." with "…Section 6041(e) of the Internal Revenue Code, relating to section does not apply to certain tips, shall not apply."

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. Thus, the author may want to consider removing Section 7 from this bill.

Policy Considerations

This bill does not provide a sunset date, which would generally allow periodic review of the effectiveness of the tax law change. If this is contrary to the author's intent, the author may wish to amend the bill.

This bill would limit the deduction for the Archer Medical Savings Account, which would negatively impact individuals who receive tips. If this is contrary to the author's intent, the bill should be amended.

LEGISLATIVE HISTORY

AB 1443 (Castillo, 2025/2026) similar to this bill, would under the PITL, for taxable years beginning on or after January 1, 2026, and before January 1, 2031, treat tips as gifts that would be excluded from gross income. Under the AFITL, this bill would exclude tips from supplemental wages subject to withholding for purposes of the wage withholding tables that are prepared by the FTB. Under the UIC, this bill would exclude tips from wages for unemployment purposes. The bill would also make changes to other related provisions. AB 1443 is currently in the Assembly Revenue and Taxation Committee.

AB 2080 (Donnelly, 2013/2014) similar to this bill, would have under the PITL, treated tips as gifts that would be excluded from gross income. Under the AFITL, would have excluded tips from supplemental wages subject to withholding for purposes of the wage withholding tables that are prepared annually by the FTB. Finally, the bill would have, under the UIC, excluded tips from unemployment purposes. AB 2080 did not pass out of the Assembly by the constitutional deadline.

PROGRAM BACKGROUND

None noted.

OTHER STATES' INFORMATION

None noted.

FISCAL IMPACT

FTB's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be determined.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB 17 as Introduced on December 2, 2024
Assumed Enactment after June 30, 2025

($ in Millions)

Fiscal Year	Revenue*
2025-2026	-$330
2026-2027	-$340
2027-2028	-$360

*This revenue estimate does not include changes in taxpayer behavior.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

This estimate is based on a proration of the Yale Budget Lab’s (YBL) estimate for the exclusion of tips from gross income. In September 2024, the YBL published an analysis of the budgetary impact of the excluding tips from income and estimated revenue impact of the exclusion would be a loss of $9 billion in federal fiscal year 2025-2026. The corresponding loss to California is estimated to be $385 million in the 2026 taxable year.

Based on data from the Internal Revenue Service Statistics of Income, it is estimated that 13 percent of nationally reported income was from California, and that the state tax rate is 33 percent of the federal tax rate. These values were combined to estimate California's corresponding loss of $385 million.

Additionally, this bill amends the definition of wages for Unemployment Insurance and as a result, the payroll tax deduction taken by employers as an ordinary and necessary business expense would decrease. Using estimated reportable tip income combined with the current FICA tax rates of 6.2 percent and the average income tax rate for businesses and self-employed individuals of 4 percent results in an offsetting revenue gain of $55 million. Combining the two results in a total revenue loss of $330 million for the 2026 taxable year.

The tax year estimates are converted to fiscal year estimates, and then rounded to arrive at the amounts reflected in the above table.

LEGAL IMPACT

None noted.

EQUITY IMPACT

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

To be determined.

ARGUMENTS

To be determined.

LEGISLATIVE CONTACT

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