

Date of Hearing: April 28, 2025

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION

Mike Gipson, Chair

AB 1443 (Castillo) – As Introduced February 21, 2025

**SUSPENSE**

Majority vote. Fiscal committee.

**SUBJECT:** Personal income taxes: unemployment insurance: tips

**SUMMARY:** Excludes from gross income, for taxable years beginning on or after January 1, 2026, and before January 1, 2031, "tips" for purposes of the Personal Income Tax (PIT) Law. Specifically, **this bill:**

- 1) Defines "tips" to include any gratuity provided by a customer or client of the employer's business.
- 2) Provides, for taxable years beginning on or after January 1, 2026, and before January 1, 2031, all of the following:
  - a) For purposes of determining gross income, Internal Revenue Code (IRC) Section 102(a) is modified to treat tips as property transferred by gift;
  - b) For purposes of calculating the deduction allowed for qualifying contributions to Archer Medical Savings Accounts, IRC Section 220(b)(4)A, is modified to strike out "tips";
  - c) For purposes of determining the taxable year of inclusion, IRC Section 451(e), relating to the special rule for employee tips, shall not apply;
  - d) For purposes of information returns for payments of \$600 or more, IRC Section 6041(e) shall not apply;
  - e) For purposes of imposing penalties on taxpayers who fail to file the required information returns, IRC Sections 6724(d)(1)(B)(xvi) and 6724(d)(2)(X), relating to reporting with respect to certain tips, do not apply; and,
  - f) For purposes of preparing wage withholding tables under the Administration of Franchise and Income Tax Laws (AFITL), "supplemental wages" does not include tips.
- 3) Provides that "wages", for purposes of the Unemployment Insurance (UI) Tax and Employment Training Tax (ETT) starting January 1, 2026, and until December 31, 2030, does not include tips.
- 4) Finds and declares the following for purposes of satisfying the requirements of Revenue and Taxation Code (R&TC) Section 41:
  - a) The specific goal of this bill is to assist individuals with retaining more of their earnings;

- b) The performance indicator for the Legislature to use in determining whether the exclusion achieves its goal is the number of returns claiming the exemption; and,
- c) Requires the Franchise Tax Board (FTB) to provide a report no later than December 1, 2036 to the Legislature detailing, to the extent data is available, the number of returns claiming the exemption.

**EXISTING FEDERAL LAW:**

- 1) Provides 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. (IRC Section 61.)
- 2) Provides various exclusions from gross income in determining income tax liability. (IRC Section 101 *et seq.*)
- 3) Requires any employee who, in the course of employment, receives in any calendar month cash tips of \$20 or more that are wages or 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(a).)
- 4) Requires employers that are large food or beverage establishments to file information returns for each calendar year with information regarding the establishment's gross receipts attributable to the provision of food and beverages, the aggregate amount of tips received, and the amount of tips allocated to each employee, as specified. (IRC Section 6053(c).)

**EXISTING STATE LAW:**

- 1) Conforms generally to federal law, which provides that "gross income" includes all income from whatever source derived unless expressly excluded. (R&TC Section 17071.)
- 2) Provides various exclusions from gross income in determining tax liability under the PIT Law. (R&TC Section 17131 *et seq.*)
- 3) Conforms generally 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. (R&TC Section 19183(d)(2)(B)).
- 4) Imposes the UI Tax on employers at specified rates on the first \$7,000 of each employee's wages, per year. (Unemployment Insurance Code (UIC) Section 100 *et seq.*)
- 5) Imposes the ETT on employers at the rate of 0.1% on the first \$7,000 of each employee's wages, per year. (UIC Section 976.6).

**FISCAL EFFECT:** The FTB estimates General Fund revenue losses of \$330 million in fiscal year (FY) 2025-26, \$340 million in FY 2026-27, and \$360 million in FY 2027-28.

**COMMENTS:**

- 1) The author has provided the following statement in support of this bill:

Tipped workers, from restaurant servers to hairdressers, rely on gratuities as a fundamental part of their income. Unlike wages set by employers, tips are voluntary expressions of customer satisfaction. Taxing them effectively penalizes workers for good service while disproportionately impacting those in lower-wage industries. AB 1443 recognizes that these earnings should remain with the workers who earn them — not be siphoned off by the government. Exempting tips from taxation would provide immediate financial relief, improve job retention, and acknowledge the essential role service industry workers play in our economy. It's time to let tipped workers keep what they rightfully earn.

- 2) Writing in support of this bill, the California Restaurant Association, notes, in part:

Tipped workers receive gratuities directly from diners as a sign of appreciation for the level of service provided- and many choose a career in hospitality because they are drawn to the earning potential and career growth. Providing tax relief to these employees will increase their earnings and addresses, in part, the affordability crisis that the Legislature is so appropriately focused on this year. When restaurant team-members and operators keep more of their hard-earned money it stimulates local economies and helps restaurant operators reinvest funds back into the people and places that make neighborhood restaurants such a strong cornerstone of communities up and down the state.

- 3) Writing in opposition to this bill, the California Federation of Teachers (CFT), notes, in part:

CFT — A Union of Educators & Classified Professionals, AFT, AFL-CIO, respectfully opposes AB 1443 (Castillo).

- 4) Committee Staff Comments:

- a) *What is a "tax expenditure"?* Existing law provides various credits, deductions, exclusions, and exemptions for particular taxpayer groups. In the late 1960s, U.S. Treasury officials began arguing that these features of the tax law should be referred to as "expenditures" since they are generally enacted to accomplish some governmental purpose and there is a determinable cost associated with each (in the form of foregone revenues).

As the Department of Finance notes in its annual Tax Expenditure Report, there are several key differences between tax expenditures and direct expenditures. First, tax expenditures are typically reviewed less frequently than direct expenditures. Second, there is generally no control over the amount of revenue losses associated with any given tax expenditure. Finally, it should also be noted that, once enacted, it takes a two-thirds vote to rescind an existing tax expenditure absent a sunset date. This effectively results in a "one-way ratchet" whereby tax expenditures can be conferred by majority vote, but cannot be rescinded, irrespective of their efficacy or cost, without a supermajority vote.

- b) *A brief history:* Since the ratification of the 16<sup>th</sup> Amendment in 1913 authorizing a federal income tax, tips have been considered part of gross income. In fact, a 1919 Treasury regulation stated that tips generally were a form of compensation for services. It was not until 1982, however, that Congress took concrete steps towards ensuring that

taxpayers actually reported tips as income. At the time, the Joint Committee on Taxation estimated the tips tax compliance rate for 1981 to be as low as 16%, with the only type of income with a lower compliance rate being illegal income at 5%.<sup>1</sup>

In an effort to improve compliance and increase revenues, the Tax Equity and Fiscal Responsibility Act (TEFRA), signed by President Reagan, required certain large food and beverage establishments to report tip-related information to the Internal Revenue Service (IRS) annually, including the gross receipts from food and beverages, the amount of aggregate charge receipts showing tips, and the tip income reported by employees.

- c) *Cash was king*: The passage of TEFRA resulted in a swift public outcry, particularly from waiters and other restaurant workers who had become accustomed to not reporting, or under-reporting, the amount of tips received. While tips had not been explicitly excluded from gross income, many believed that the lax enforcement from tax authorities implicitly sanctioned such tax evasion. Up until this point, cash was the main method of payment for most customer, making it fairly easy to pocket those dollars at the end of a shift without any serious concerns that there would be a paper trail for taxing authorities to follow if one underreported the amounts actually taken home.

In 2006, the Treasury Inspector General for Tax Administration estimated that the compliance rate for reporting tips rose to 48%, a modest increase that is likely due both to the requirements of TEFRA and the increased use of electronic point-of-sale systems that could process debit and credit card transactions. While it is likely that the proportion of tips reported has continued to rise with subsequent advances in technology, the IRS has not published updated figures since 2006. Still, the proportion of tips reported to the IRS is likely at an all-time high, which may explain the renewed interest in the exclusion of tips for tax purposes.

- d) *Tipping now*: According to a Pew Research survey from 2023, 72% of Americans have seen an expansion of tipping expectations over the past five years, a finding that matches anecdotal reporting and has even been dubbed "tipflation".<sup>2</sup> According to a 2025 WalletHub survey:

- i) Nearly 9 in 10 Americans think tipping culture has gotten out of control;
- ii) Nearly 3 in 5 Americans think businesses are replacing employee salaries with customer tips;
- iii) 83% of respondents think automatic service charges should be banned; and,

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<sup>1</sup> Jeane, *Tips To Tax or Not to Tax – That is the (Tax Policy) Question*, Tax Notes State, Volume 115 (March 31, 2025). <https://www.taxnotes.com/tax-notes-today-state/tax-policy/tips-tax-or-not-tax-tax-policy-question/2025/03/27/7rl5j>.

<sup>2</sup> Desilver and Lippert, *Tipping Culture in America: Public Sees a Changed Landscape*, Pew Research Center (November 9, 2023). <https://www.pewresearch.org/2023/11/09/tipping-culture-in-america-public-sees-a-changed-landscape/>.

iv) More than 1 in 4 Americans think tips should be taxed.<sup>3</sup>

- e) *Who stands to benefit?* The Yale Budget Lab estimated that, in 2023, approximately four million people in the U.S. worked in a tipped occupation, representing roughly 2.5% of all employment.<sup>4</sup> More than one-half of reported tips (54.1%) were earned in the restaurant and other food services industry, with waiters receiving 27%, bartenders receiving 19.8%, and couriers and messengers receiving 10.5%.<sup>4</sup>

It is further estimated that women represented more than 71% of tipped workers nationally, despite composing only 47% of the workforce that year. Women of color were most likely to be tipped workers, representing over 29% of all tipped workers nationally.<sup>5</sup> Researchers at the Economic Policy Institute have found that the overrepresentation of women – and women of color in particular – is largely driven by the fact that 11 southern states impose a minimum wage of \$2.13-per-hour for tipped workers.<sup>6</sup>

In California, however, the minimum wage is the same for tipped and non-tipped workers. Given this and other important distinctions between California and the nation as a whole, the distributional effects of the proposed policy are difficult to estimate with precision.

- f) *Committee's tax expenditure policy:* Both R&TC Section 41 and Committee policy require any tax expenditure bill to outline specific goals, purposes, and objectives that the tax expenditure will achieve, along with detailed performance indicators for the Legislature to use when measuring whether the tax expenditure meets those stated goals, purposes, and objectives. A tax expenditure bill will not be eligible for a Committee vote unless it has complied with these requirements.

In its current form, this bill states that the income exclusion is designed to assist individuals with retaining more of their earnings. In addition, this bill provides that the exclusion's effectiveness shall be measured by the number of taxpayers claiming the exclusion.

In addition to the R&TC Section 41 requirements, this Committee's policy also requires that all tax expenditure proposals contain an appropriate sunset provision to be eligible for a vote. According to this policy, an "appropriate sunset provision" means five years,

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<sup>3</sup> McCann, *Tipping Survey*, WalletHub (March 11, 2025). <https://wallethub.com/blog/tipping-survey/135092>.

<sup>4</sup> Tedeschi, *The "No Tax on Tips Act": Background on Tipped Workers*, The Budget Lab at Yale University (June 24, 2024). <https://budgetlab.yale.edu/research/no-tax-tips-budgetary-distributional-and-tax-avoidance-considerations>.

<sup>5</sup> Airi and Hunter, *Tipped Workers, Their Income Taxes, and States*, Urban-Brookings Tax Policy Center (August 23, 2024). <https://taxpolicycenter.org/taxvox/tipped-workers-their-income-taxes-and-states>.

<sup>6</sup> Mast, *Tipping Is a Racist Relic and a Modern Tool of Economic Oppression in the South*, Economic Policy Institute (June 18, 2024). <https://www.epi.org/publication/rooted-racism-tipping/>.

except in the case of a tax expenditure measure providing relief to California veterans, in which case "appropriate sunset provision" means ten years. This bill, as currently drafted, complies with the Committee's policy on sunset dates.

g) *Policy considerations:*

- i) *What are we incentivizing?* A tax break that favors one form of income over others creates opportunities and incentives for tax avoidance. This policy change could motivate more employees and businesses to move towards a tip-based payment approach according to the Tax Foundation, which could make tipping even more commonplace across industries.<sup>7</sup> Such behavioral responses could result in revenue impacts that are significantly larger than what is currently estimated under a static model of the economy.

One way that similar proposals have attempted to prevent this kind of gaming is by limiting the income exclusion to specific industries that have historically relied on tips. For example, Kamala Harris during her presidential campaign proposed exempting tips from income taxes for workers in the hospitality and service industries, as well as limiting the benefit based on a taxpayer's overall income.

- ii) *How much of a benefit is this really?* The Yale Budget Lab estimates that less than 5% of workers making less than \$25 per hour currently receive tips. In other words, among the bottom half of U.S. workers by earnings, less than 1 in 20 earn tips. Thus, roughly 95% of low- and moderate-wage workers do not earn tips and therefore would not benefit from this income exclusion.

Additionally, exempting tips from income taxes does not help tipped workers whose earnings are so low that they are already exempt from income taxes. Nationally, it is estimated that more than one-third of tipped workers do not pay any income tax before tax credits.<sup>8</sup> In California, that figure may be even higher due to the progressive nature of our income tax structure and minimum filing thresholds.

- iii) *Unemployment insurance fund already in trouble:* As documented extensively by the Legislative Analyst's Office (LAO), California's UI financing system is not working as intended. Tax collections routinely fall short of covering benefit costs, creating annual shortfalls of roughly \$2 billion per year for the next five years.<sup>9</sup> The taxable wage base for both the UI tax and ETT is limited to the first \$7,000 earned by an employee, which is one of the lowest in the nation. The LAO has recommended that the Legislature, among other reforms, substantially increase the taxable wage base to make the UI system more sustainable.

While many employees who earn tips would likely meet this threshold based on their

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<sup>7</sup> Muresianu, *Frustrated with Tipping? No Tax on Tips Could Make It Worse*, Tax Foundation (January 30, 2025). <https://taxfoundation.org/oped/no-tax-on-tips-could-backfire/>.

<sup>8</sup> Tedeschi *supra*.

<sup>9</sup> Alamo and Hollingshead, *Fixing Unemployment Insurance*, LAO (December 2, 2024). <https://lao.ca.gov/Publications/Report/4943>.

wages alone, it is possible that this bill results in a reduction in UI tax and ETT revenues because it would exempt tips from being counted towards that \$7,000 taxable wage base.

h) *Technical considerations:*

- i) *Definition of tips:* As currently drafted, this bill defines "tips" to include any gratuity provided by a customer or client of the employer's business. This definition may be 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. The author may wish 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).
- ii) *Section 41 language:* As currently drafted, this bill states that the performance indicator for the Legislature to use in determining whether the exclusion achieves its goal is the number of returns claiming the exemption. Income exclusions, however, are not typically reported on the income tax return and there are no provisions in this bill requiring taxpayers to provide this information to the FTB. Thus, this bill should be amended to be consistent with R&TC Section 41(a)(2), which provides that bills authorizing a new gross income exclusion are exempt from the performance indicator requirement if the Legislature determines that there is no data to collect and report.
- iii) *Cross-references and conformity:* As currently drafted, this bill contains multiple cross-references to federal law, some of which appear unnecessary. For example, California already does not conform to federal law for purposes of large food and beverage establishments reporting specified information relating to tips.
- i) *Related legislation:* SB 17 (Ochoa Bogh) is substantially similar to this bill and is currently pending hearing by the Senate Revenue and Taxation Committee.
- j) *Prior legislation:* AB 2080 (Donnelly), of the 2013-14 Legislative Session, was substantially similar to this bill. AB 2080 was held on this Committee's Suspense File.

**REGISTERED SUPPORT / OPPOSITION:**

**Support**

California Restaurant Association

**Opposition**

California Federation of Teachers

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