

Date of Hearing: April 27, 2026

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION

Mike Gipson, Chair

AB 1550 (Sanchez) – As Amended March 16, 2026

SUSPENSE

Majority vote. Tax levy. Fiscal committee.

SUBJECT: Personal income taxes: deductions: tips: overtime compensation

SUMMARY: Conforms California's Personal Income Tax (PIT) Law to federal law that allows "above-the-line" deductions of "qualified tips" and "qualified overtime compensation" for taxable years beginning on or after January 1, 2026, and before January 1, 2029. Specifically, **this bill:**

- 1) Conforms to federal law that allows a deduction of up to \$25,000 for "qualified tips" received during the taxable year.
- 2) Conforms to federal law that allows a deduction of up to \$25,000 for "qualified overtime" received during the taxable year.
- 3) Finds and declares the following for purposes of satisfying the requirements of Revenue and Taxation Code (R&TC) Section 41:
 - a) The specific goals, purposes, and objectives of the deductions provided by this bill are to help struggling workers retain more of their earnings; and,
 - b) To measure whether this bill achieves its intended purpose, the Franchise Tax Board (FTB) is required to submit a written report to the Legislature by December 1, 2029, and annually thereafter, summarizing the number of taxpayers claiming either deduction and the average dollar value of those amounts deducted.
- 4) Takes immediate effect as a tax levy.

EXISTING FEDERAL LAW:

- 1) Allows a deduction of up to \$25,000 for "qualified tips" received during the taxable year beginning on or after December 31, 2024, and before January 1, 2029. (Internal Revenue Code (IRC) Section 224.)
 - a) Reduces the deduction by \$100 for each \$1,000 by which the taxpayer's modified adjusted gross income (MAGI) exceeds \$150,000 (\$300,000 for married couples filing jointly). The deduction phases out fully for filers earning above \$400,000 (\$550,000 for those married filing jointly).

- b) Provides that this deduction is in addition to the standard deduction for taxpayers who do not itemize.
 - c) Requires married taxpayers to file jointly to claim the deduction.
 - d) Requires taxpayers to file with a social security number (SSN) to claim the deduction; taxpayers filing with an individual taxpayer identification number (ITIN) are ineligible.
 - e) Defines "qualified tips" as cash tips received by an individual working in an occupation which customarily and regularly received tips on or before December 31, 2024, as determined by the U.S. Secretary of the Treasury.
 - f) Excludes from "qualified tips" any amount received by an individual unless the amount satisfies all of the following:
 - i) The amount received is paid voluntarily without any consequences for nonpayment, is not the subject of negotiation, and is determined by the payor;
 - ii) The trade or business in which the individual receives the amount is not a specified service trade or business as defined in IRC Section 199A(d)(2); and,
 - iii) Other requirements established by the Treasury Secretary in regulations or other guidance are satisfied.
- 2) Allows a deduction of up to \$25,000 for "qualified overtime" received during the taxable year beginning on or after December 31, 2024, and before January 1, 2029. (IRC Section 225.)
- a) Reduces the deduction by \$100 for each \$1,000 by which the taxpayer's MAGI exceeds \$150,000 (\$300,000 for married couples filing jointly). The deduction phases out fully for filers earning above \$400,000 (\$550,000 for those married filing jointly).
 - b) Provides that this deduction is in addition to the standard deduction for taxpayers who do not itemize.
 - c) Requires married taxpayers to file jointly to claim the deduction.
 - d) Requires taxpayers to file with SSN to claim the deduction; taxpayers filing with an ITIN are ineligible.
 - e) Defines "qualified overtime" as the overtime compensation paid to an individual required under section 7 of the Fair Labor Standards Act of 1938 that is in excess of the regular rate at which such individual is employed. Qualified tips, as defined in IRC Section 224, are excluded.

EXISTING STATE LAW does not conform to the above deductions.

FISCAL EFFECT: The FTB estimates that this bill will result in a General Fund revenue loss of \$2.6 billion in fiscal year (FY) 2026-27, \$1.5 billion in FY 2027-28, and \$650 million in FY 2028-29.

COMMENTS:

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

Californians relying on tips or overtime to support their families should not be penalized for working harder. This is about making California more affordable and giving working and middle-class families a fair shot. When people are working extra hours just to keep up, the state should be helping, not making it harder.

- 2) This bill is supported by the California Restaurant Association, which notes, in part:

The tipped workforce is vital to California's economy, and when workers keep more of their earnings, they spend more, reinvesting in themselves, their families, and their communities. Additionally, while segments of the restaurant community have a high concentration of tipped workers, the U.S. Treasury Department reports that at least 68 other professionals also receive tips and qualify for taxable income relief under federal legislation. 36 states automatically adopt federal tax policy into their state code. Other states, including California, need to adopt these changes to alter their state's income tax treatment of tips and overtime in order for the workforce to benefit.

- 3) This bill is opposed by the California Tax Reform Association, which notes, in part:

Conformity to the federal tax code needs to be taken as a whole. The estimated cost of eliminating the tax on tips is \$600 million, declining over the next few years and then zero when ended. There are billions at stake in the conformity discussion, and this major revenue loss must be part of that discussion.

- 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) *Conformity in California:* California tax law does not automatically conform to federal tax law changes. For the state to adopt changes to federal tax law, individual tax bills conforming to specific federal changes, or an omnibus bill conforming to federal tax law as of a certain date, are required. Unlike the Federal Government, the California Constitution requires the Legislature and Governor to pass a balanced budget. Thus, the

Legislature has chosen to selectively conform to federal tax law as of a certain date, allowing prudent examination of the potentially costly changes made by the federal government before adoption by California.

Last year, the Legislature passed and Governor Newsom signed SB 711 (McNerney), Chapter 231, Statutes of 2025, which conformed California tax law to the IRC as of January 1, 2025, with certain modifications. SB 711 generally maintained non-conformity where California has specifically decoupled from wholesale elements of federal law, such as federal tax credits and their carryover periods.

- c) *Taxation of tips*: Tips have been considered income and been subject to taxation since the ratification of the 16th Amendment in 1913 but were often unreported because they were difficult to track in a primarily cash-based economy.¹ In an effort to improve compliance and increase revenues, the Tax Equity and Fiscal Responsibility Act (TEFRA), signed by President Reagan in 1982, required certain large food and beverage establishments to report tip-related information to the IRS, including the gross receipts from food and beverages, the amount of aggregate charge receipts showing tips, and the tip income reported by employees.

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 customers, 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 the modern era of credit and debit cards and mobile payments, however, tips are much easier to track.

- d) *"No tax on tips"*: The One Big Beautiful Bill Act (OBBBA) did not change this longstanding practice of treating tips as taxable income. Rather, it provided a deduction of up to \$25,000 for "qualified tips", meaning a qualifying taxpayer can subtract up to that amount in tips received from their gross income. Importantly, this is an "above-the-line" deduction, which means it can be claimed in addition to the standard deduction, and the taxpayer does not have to itemize. In other words, tips are still income and are still reported to the IRS, but the deduction reduces the taxpayer's gross income by the amount of "qualified tips" they received.

To prevent gaming and the reclassification of other forms of income as "tips" to avoid taxation, the OBBBA limits "qualified tips" to those occupations that customarily and regularly received tips on or before December 31, 2024. Treasury Secretary Bessent published a preliminary list of over 200 occupations in September 2025 and the Office of

¹ 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>.

Management and Budget (OMB) is currently reviewing the finalized list.²

Tips earned by nonemployee workers (such as independent contractors) can qualify to the extent they exceed the cost of goods sold and other expenses, losses, or deductions allocable to the service provided. Tip income from "specified service trades and businesses," as defined for purposes of the qualified business income deduction, does not qualify for the tip deduction. Finally, qualifying tips must be paid voluntarily, be determined by the payor, and not be subject to negotiation, among other rules.

- 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.³ 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%.³

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.⁴ 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.⁵

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) *Overtime pay:* Unless specifically exempt, employees covered by the Fair Labor Standards Act (FLSA) must receive overtime pay for hours worked in excess of 40 in a workweek at a rate not less than time and one-half their regular rates of pay.⁶ There is no limit on the number of hours employees aged 16 and older may work in any workweek. An employee's workweek is a fixed and regularly recurring period of 168 hours – seven

² Sikes, *OIRA Reviewing Finalized List of Jobs for Tips Deduction*, Tax Notes Federal, Volume 190 (March 9, 2026). <https://www.taxnotes.com/tax-notes-today-federal/exemptions-and-deductions/oira-reviewing-finalized-list-jobs-tips-deduction/2026/03/05/7v13y>.

³ 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>.

⁴ 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>.

⁵ 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/>.

⁶ *Fact Sheet #23: Overtime Pay Requirements of the FLSA*, Department of Labor (October 2019). <https://www.dol.gov/agencies/whd/fact-sheets/23-flsa-overtime-pay>.

consecutive 24-hour periods. The FLSA does not require overtime pay for work on Saturdays, Sundays, holidays, or regular days of rest.

Under the FLSA, the regular rate of pay cannot be less than the minimum wage. The regular rate includes all remuneration for employment except certain payments excluded by the FLSA itself, including pay for expenses incurred on the employer's behalf, premium payments for overtime work, discretionary bonuses, gifts and payments in the nature of gifts on special occasions, and payments for occasional periods when no work is performed due to vacation, holidays, or illness.

- g) *"No tax on overtime"*: Similar to the tip deduction, the OBBBA did not fully exempt overtime wages from taxation and instead created an "above-the-line" deduction that could be claimed in addition to the standard deduction. Importantly, the OBBBA's overtime provisions only apply to the portion of overtime pay that exceeds the employee's regular rate of pay and is required under Section 7 of the FLSA. In other words, under a typical "time and a half" scenario, only the additional one-half premium qualifies for the deduction. The full overtime wage (including the regular rate portion) is not deductible. Additionally, overtime paid solely under state law, a collective bargaining agreement, or employer policy – if not required by the FLSA – does not increase the deductible amount.⁷
- h) *Who stands to benefit?* Because the overtime deduction is based on the FLSA's overtime provisions, only non-exempt employees can receive the tax benefit. To be considered exempt from overtime and minimum wage laws, an employee usually must satisfy three specific tests. First, the salary basis test requires that the person receives a set salary that does not change based on the quality or quantity of their work. Second, the salary level test requires that this salary meets a minimum amount, which is currently set at \$684 per week, or \$35,568 annually. Finally, the duties test looks at the actual work being performed to ensure it matches the requirements for a specific exemption, which are numerous and range from professional and administrative employees to first responders.⁸
- i) *Tips and overtime pay are still subject to payroll taxes*: Tips and overtime pay are generally considered wages for payroll tax purposes, both now and prior to passage of the 2025 reconciliation law. Federal payroll taxes include taxes on both the employee and employer of 6.2% of a worker's wages up to a taxable maximum (\$176,100 in 2025) to finance the Social Security trust funds, as well as a tax of 1.45% of a worker's wages to finance the Medicare Hospital Insurance trust fund; these taxes are commonly referred to as Federal Insurance Contribution Act (FICA) taxes. Individuals also pay an Additional Medicare Tax of 0.9% on compensation exceeding \$200,000 (\$250,000 for couples married filing jointly; \$125,000 if married filing separately). The Tax Policy Center estimates that roughly 67% of households with incomes below \$100,000 in 2023 paid

⁷ *FS-2026-01 Questions and answers about the new deduction for qualified overtime compensation*, Internal Revenue Service (January 2026).

<https://www.irs.gov/newsroom/questions-and-answers-about-the-new-deduction-for-qualified-overtime-compensation>.

⁸ *Fact Sheet #17B: Exemption for Executive Employees Under the FLSA*, Department of Labor (August 2024). <https://www.dol.gov/agencies/whd/fact-sheets/17b-overtime-executive>.

more in payroll taxes (including both employee- and employer-side taxes, as employers may pass the employer-side tax onto workers in the form of lower wages) than in individual income taxes.

- j) *ITINs and married filers:* An ITIN is a nine-digit number the IRS issues individuals who are not eligible for an SSN and allows them to file legally required income tax returns, claim certain benefits, and be claimed as a spouse or a dependent by another taxpayer. People who do not have a lawful status in the United States may obtain an ITIN. Other people who are lawfully present in the country and must pay taxes, but who may not be eligible for an SSN, may also obtain an ITIN. Examples include a foreign national legally residing in the United States such as a student or professor who is required to file a U.S. tax return, a dependent or spouse of a U.S. citizen or lawful permanent resident, and a dependent or spouse of a foreign national on a temporary visa. According to the IRS, in 2022, approximately 3.8 million tax returns included an ITIN with a total taxable income of approximately \$14.4 billion and total Social Security and Medicare taxes of \$6.5 billion.⁹

Despite the significant tax contributions of ITIN filers to public coffers, the OBBBA specifically denies the qualified tips and overtime deductions to ITIN filers. Further, because married taxpayers must file jointly with their spouses to claim these deductions, the spouses of ITIN holders cannot receive these benefits. Typically, married couples can choose to file taxes separately and are entitled to receive one-half of the corresponding benefit.

This bill conforms to the OBBBA provision that disqualifies ITIN filers from claiming these deductions. Thus, this bill would not allow any married couple consisting of at least one ITIN filer to claim the qualified tips and overtime deductions on their California income tax returns. The Committee may wish to consider whether this is fair considering the other tax benefits that California makes available to ITIN filers.

k) *Technical considerations:*

- i) *Report timeline:* This bill would require the FTB to submit a report to the Legislature detailing the number of taxpayers that claim the deductions and the average dollar value of deductions allowed by December 1, 2029. If the author's intent is to review a report that contains complete information for the 2026 through 2028 taxable years, the FTB recommends that the reporting due date be extended to July 2030.
- ii) *Separate code sections:* As currently drafted, this bill creates a new code section in the R&TC containing both the qualified tips and overtime compensation deductions. For consistency with deductions listed in the R&TC and for taxpayer ease, the FTB recommends that two separate R&TC sections be created for each deduction.

l) *Related legislation:*

⁹ *The Facts About the Individual Taxpayer Identification Number (ITIN)*, American Immigration Council (June 25, 2025). <https://www.americanimmigrationcouncil.org/fact-sheet/facts-about-individual-tax-identification-number-itin/>.

- i) SB 984 (Ochoa Bough) is substantially similar to this bill but requires the FTB to create the list of occupations that customarily and regularly received tips on or before December 31, 2024. SB 984 is currently pending hearing by the Senate Committee on Revenue and Taxation.
- ii) AB 1443 (Castillo) would have treated tips as gifts that were excluded from gross income for purposes of the PIT and unemployment tax. AB 1443 was held on this Committee's Suspense File.
- iii) SB 17 (Ochoa Bogh) was substantially similar to AB 1443. SB 17 was held on the Senate Appropriations Committee's Suspense File.
- m) *Prior legislation:* AB 2080 (Donnelly), of the 2013-14 Legislative Session, was substantially similar to AB 1443. AB 2080 was held on this Committee's Suspense File.

REGISTERED SUPPORT / OPPOSITION:**Support**

California Assisted Living Association
California Restaurant Association
California Society of Enrolled Agents
SFV Alliance
Southwest California Legislative Council

Opposition

CFT – a Union of Educators & Classified Professionals, AFT, AFL-CIO
California Tax Reform Association
California Teachers Association

Analysis Prepared by: Wesley Whitaker / REV. & TAX. / (916) 319-2098