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ARIZONA WITHHOLDING TAX RULING WTR 16-1

(This ruling supersedes Arizona Withholding Tax Ruling WTR 92-1)

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ISSUE:

Arizona Withholding Requirements Imposed On Tip Income

1. When the amount required to be deducted by an employer is more than the employee's regular wage (the wages under the control of the employer) due to the requirement to withhold on tip income, does Arizona recognize the federal priorities established by Treas. Reg. § 31.3402(k)-1?
2. If Arizona does recognize the federal priorities for withholding taxes, will the employer still be required to remit the total withholding for Arizona purposes when the amount required to be deducted by the employer is more than the amount of wages under the control of the employer?

RULING:

For Arizona withholding tax purposes, tips which are reported to an employer by an employee which are subject to federal withholding are likewise subject to Arizona withholding. In the situation where the amount of required federal and Arizona withholding on tip income exceeds the amount of wages available from which withholding may be made, the Department will recognize the payment application structure established by Treas. Reg. § 31.3402(k)-1. The employer is required to withhold as follows:

1. The employer is first required to withhold federal and Arizona taxes imposed on the regular wage.

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2. After the required withholding in number 1 has been satisfied, the remaining regular wage must then be used to satisfy the required federal withholding imposed on the employee's tip income.
3. After the withholding required in numbers 1 and 2 have been satisfied, the remaining regular wage, if any, must be used to satisfy the applicable Arizona withholding on the tip income.

Therefore, in this situation, the employer is only required to withhold Arizona taxes on tip income to the extent that the tax can be deducted and withheld from the wages under the employer's control. If the current wage under the employer's control is not sufficient to satisfy the amount required to be withheld for Arizona purposes, then the employer must withhold such unsatisfied amounts from the remaining regular wage in the following pay period or succeeding pay periods during the calendar year.

DISCUSSION:

For federal purposes, Internal Revenue Code (I.R.C.) § 3402(a)(1) requires every employer making payment of wages to deduct and withhold upon such wages a tax determined in accordance with prescribed tables or a prescribed mathematical formula. For federal withholding tax purposes, I.R.C. § 3401(f), defines the term "wages" to include tips received by an employee in the course of his or her employment. Tips are deemed to be paid at the time the employee furnishes the employer with a written statement regarding the receipt of such tips or, if no statement is furnished, at the time the tips are received.

In some instances, an employee's remuneration may consist almost entirely of tips with the regular wages being nominal. In this situation, the amount required to be withheld may be in excess of the amount of wages under the employer's control. If the amount required to be deducted by the employer is more than the employee's regular pay, the employee may voluntarily pay to the employer money which the employer may apply to withholding taxes.

If the employee does not voluntarily furnish additional funds to cover the amounts required to be withheld, Treas. Reg. § 31.3402(k)-1 establishes priorities for the application of the employee's wages to the taxes that must be withheld. Under Treas. Reg. § 31.3402(k)-1, the taxes imposed with respect to the regular wage must be satisfied first. The amounts first withheld from the regular wage must be applied in the following order: (1) I.R.C. § 3101 (F.I.C.A.), (2) I.R.C. § 3402 (Income Tax at Source) and (3) State and local taxes. After the withholding from the regular wage has been satisfied, the employer must then deduct and withhold federal taxes imposed on tip income from the remaining wage. Under the federal procedures, if the amount of remaining wage is not sufficient to cover the federal amount required to be withheld on tip income, the amount of tax which remains unsatisfied should be withheld from the wages under the control of the employer the following pay period.

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For Arizona withholding tax purposes, Arizona Revised Statutes (A.R.S.) §§ 43-102 and 43-105 conform the Arizona definition of wages to the federal definition of wages. Therefore, amounts included in wages and subject to mandatory federal withholding are likewise subject to Arizona withholding. Tips which are reported to an employer by an employee which are considered to be wages for federal purposes and subject to mandatory federal withholding are likewise subject to Arizona withholding. Arizona statutes do not have any exceptions to this requirement.

Under A.R.S. § 43-401 every employer at the time of the payment of wages, salary, bonus or other emolument to any employee whose compensation is for services performed within this state shall deduct and retain from the compensation an amount that is determined pursuant to tables adopted by the department.

The department's withholding tables are based on a percentage of gross taxable wages. "Gross taxable wages" is the amount that meets the federal definition of "wages" contained in IRC § 3401 and that will generally be included in box 1 of the employee's federal Form W-2 at the end of the calendar year (i.e. gross wages net of pretax deductions, such as the employee's portion of health insurance premiums). Therefore, since Arizona's withholding is based on wages as defined under the internal revenue code, Arizona recognizes and conforms to the federal priorities established under Treas. Reg. § 31.3402(k)-1.

Under Treas. Reg. § 31.3402(k)-1, when the employee's regular wage is not sufficient to cover the entire amounts required to be withheld on tip income, the amount of funds in the employer's control (i.e., remaining regular wage) must first be applied to any required federal withholding on tips. In this situation the employer may not have sufficient wages from which to deduct the Arizona withholding. Since A.R.S. § 43-401 requires the Arizona withholding amounts to be deducted from the wages, the required Arizona withholding amount on tip income will be limited when the funds available for distribution are restricted under this Treasury regulation.

APPLICABLE LAW:

1. A.R.S. § 42-1004(A)(1) provides the general powers and duties of the Department, which authorizes the Department to formulate policies, plans and programs to effectuate the missions and purposes of the Department.

2. A.R.S. § 43-102(A)(1) provides that the legislature's intent in adopting Title 43 is to adopt the provisions of the Internal Revenue Code relating to the measurement of adjusted gross income.

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3. A.R.S. § 43-105 defines "Internal Revenue Code" to mean the United States internal revenue code of 1986, as amended, and in effect on a specific date.

4. A.R.S. § 43-401(A) provides that the amount an employer is to deduct and retain from wages is an amount prescribed by tables adopted by the department. Arizona withholding is based on a percentage of gross taxable wages. "Gross taxable wages" is the amount that meets the federal definition of "wages" contained in IRC § 3401 and that will generally be included in box 1 of the employee's federal Form W-2 at the end of the calendar year (i.e. gross wages net of pretax deductions, such as the employee's portion of health insurance premiums).

5. I.R.C. § 3401(f) defines the term "wages" to include tips received by an employee in the course of his or her employment. Such wages (tips) are deemed to be paid at the time the employee furnishes the employer with a written statement regarding the receipt of such tips, or if no statement is furnished, at the time the tips are received.

6. I.R.C. § 3402(a)(1) requires every employer making payment of wages to deduct and withhold upon such wages a tax determined in accordance with prescribed tables or a prescribed mathematical formula.

7. Treas. Reg. § 31.3402(k)-1 establishes priorities for the application of the employee's wages to the taxes that must be withheld.

Grant Nülle, Deputy Director

Signed: July 25, 2016

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.