Mobility Matters

The Year-end Payroll Pivot: Top Considerations for Modern Workforces for 2025–2026 Reporting and Compliance

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A steady stream of federal and state legislative changes is reshaping the landscape of payroll and employment tax, leaving many employers and their mobility teams seeking clarity on year-end processes. As 2025 draws to a close, professionals should prepare for new wage-base thresholds, expanded benefits limits, added reporting requirements for tips and overtime, and a shifting patchwork of state rules. The recent KPMG TaxWatch webcast, "Year-end payroll considerations for 2025 reporting and 2026 compliance," provided a timely and thorough briefing on what's changing, what's at stake, and how payroll teams can pivot.

One Big Beautiful Bill Act : A game-changer for tips and overtime

P.L. 119–21, the One Big Beautiful Bill Act (OB3), signed into law on July 4, 2025, has introduced two provisions likely to reshape year-end calculation and reporting for many employers:

Qualified tips

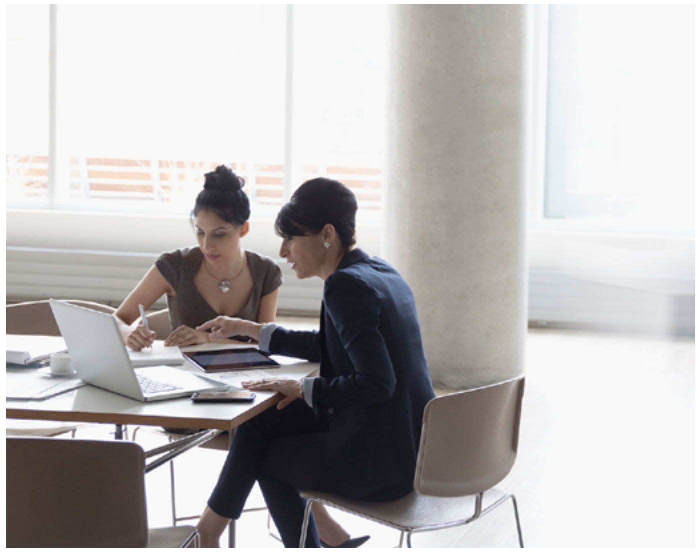
- From 2025 through 2028, employees in occupations where tipping was customary before 2025 may qualify for an above-the-line deduction up to $25,000.
- Importantly, "qualified tips" exclude any mandatory service charges and must be voluntary payments from the customer.
- While employers are not obligated to withhold differently for 2025, the Internal Revenue Service (IRS) encourages them to furnish employees with the total qualified tips so individuals can claim the deduction properly on their personal returns.
- A dedicated box (Box 12, code "TP") will appear on the 2026 Form W-2. For 2025, though, employers may choose to use a "catch-all" box (e.g., Box 14) or a separate statement.

Qualified overtime

- "Qualified OT" is defined as the half-time premium portion of overtime pay required by the Fair Labor Standards Act (FLSA). For instance, if an employee's base hourly rate is $10 and overtime is time-and-a-half ($15), then the qualified portion is $5.
- High-overtime states (such as California, which has double-time pay) must still revert to the FLSA baseline in determining the half-time premium for this deduction.
- The maximum individual deduction stands at $12,500 ($25,000 for joint filers), with no employer withholding changes mandated for 2025.
- In 2026, this figure will be reported in a new W-2 line (Box 12, code "TT"). During 2025, employers can find themselves performing extra calculations to identify just the half-time premium under FLSA standards.

For 2025, employers have flexibility in reporting qualified tips and overtime (Box 14 or separate statement), and the IRS has granted penalty relief if these are not separately listed on the W-2, provided all other reporting is accurate. For 2026, new W-2 codes ("TP" for tips, "TT" for overtime) become mandatory.

To ease this burden, the IRS has granted penalty relief for 2025 if employers do not separately list these amounts on the W-2, provided all other reporting is accurate. That said, it remains highly advisable to determine a consistent process for issuing tips and overtime details—whether built into payroll runs or through a stand-alone employee statement.



2026 headliners: Social Security wage base and retirement limits

One of the most significant updates for the coming year is the Social Security wage base increase to $184,500 in 2026, rising from $176,100 in 2025. While this bump may appear incremental, it may present notable compliance implications. An organization's payroll system should be adjusted to apply the right rate and stop withholding at the new threshold. Meanwhile, Medicare tax remains unchanged—1.45 percent on all covered wages, plus an extra 0.9 percent once an employee's wages exceed $200,000.

Equally critical are the new contribution ceilings impacting employees' retirement and benefit plans. In 2026, the 401(k) and 403(b) deferral limits will rise to $24,500, while catch-up contributions for those 50 or older in 2026 move to $8,000. Employees aged 60 to 63 in 2026 can contribute up to $12,000 in catch-ups, an option that may prompt new conversations in open enrollment. Meanwhile, defined-contribution retirement plan limits jump from $70,000 in 2025 to $72,000 in 2026.

Several other benefit limit increases affect tax-free benefits and reimbursements. For example, the monthly transit and parking cap grows to $340, the health flexible spending account limit climbs to $3,400, and the health spending account contribution ceilings move to $4,400 (single) or $8,750 (family). While these rising limits offer additional savings opportunities for employees, they also emphasize the need to update payroll codes and educate employees well before the new year begins.

State and FUTA-driven dynamics

Beyond federal shifts, individual states continue to shape payroll policy through diverse legislation:

- **Federal Unemployment Tax Act (FUTA) credit reductions:** California sees its fourth consecutive year of FUTA credit reduction, elevating its effective rate to 1.8 percent. Employers in the state pay $126 per employee in federal unemployment taxes, compared with the usual $42 for most other states. The US Virgin Islands remains under a larger reduction schedule, with even steeper effective rates.
- **T+1 settlement rule:** For large equity transactions that trigger next-day deposit rules, the settlement period is shortening from "T+2" to "T+1." Specifically, once the $100,000 threshold is reached for withheld taxes, deposits must now be made by two days from the transaction date.
- **Paid family and medical leave (PFML) programs:** Delaware's PFML system launched contributions at the start of 2025, with claims beginning in January 2026. Maryland postponed its contribution start date to January 2027, though the exact rates will be announced by May 2026. Minnesota begins its new PFML program on January 1, 2026, imposing a 0.88 percent combined employer contribution (allowing half—0.44 percent—to be deducted from employees).
- **Expanding state withholding exceptions:** Alabama, for instance, will not tax nonresident compensation in 2026 if the employee works in-state 30 days or fewer, is employed in more than one state, and meets other statutory criteria.

Common year-end pitfalls and how to avoid them

Amid new rules and greater complexity, several "classic" missteps can derail an otherwise smooth year-end close:

- **Underreported fringe items:** Any gift cards, spousal travel reimbursements, or other taxable perks outside regular payroll pose a hazard. If you're relying on accounts payable systems for these payments, track them now rather than scramble in December.
- **State wage allocations:** Remote work and multistate travelers demand accurate sourcing of wages. Overlooking short stints in certain states often leads to W-2C filings.
- **Poor departmental coordination:** Human resources (HR), payroll, mobility, and finance must stay aligned—especially if the benefits or third-party vendors have changed midyear. Think of year-end as a "compliance intersection" where data sharing is vital.
- **W-2 errors:** An outdated employee name, incorrect box codes, or a missed address update can trigger a chain reaction of W-2Cs and 941-X forms. Don't forget to verify name and Social Security number consistency, as well as newly mandatory or adjusted lines (especially for OB3 items in 2026).

Good practices: Start now, communicate often

The antidote to year-end headaches is a well-sequenced plan:

Update your systems early

Verify with in-house or third-party payroll providers that the 2026 wage bases, benefit ceilings, and new codes (especially for OB3 reporting) will be ready before your first payroll of the new year.

Collect data for qualified tips and overtime

For 2025 reporting, decide whether you'll use W-2 Box 14 or a separate statement. Work with your payroll teams to track exactly which overtime pay is "qualified" under FLSA standards—particularly in states with double-time or daily overtime rules.

Collaborate across departments

Fringe-benefit information might surface from HR, finance, benefits administrators, or even managers with their own informal "reward" practices. Year-end success depends on cross-functional coordination, especially for globally mobile employees.

Communicate with employees

OB3's "No Tax on Tips" and "No Tax on Overtime" provisions can sow confusion if employees suspect they should see zero withholding on all tips or overtime. Provide gentle "FYI" materials that explain the half-time overtime premium and the optional above-the-line deductions at the individual level.

Confirm final deadlines

W-2s, 1099s, and accompanying payroll tax returns often fall due on or near January 31—though 2026 sees some extensions to February 2. Keep in mind the new minimum thresholds for 1099-NEC/1099-MISC ($2,000) apply to payments made after January 1, 2026.

Quick reference: 2026 payroll changes

Qualified tips	2025	2026
Social Security wage base	$176,100	$184,500
401(k) deferral limit	$23,500	$24,500
Transit/Parking limit	$325/month	$340/month
1099-NEC/MISC threshold	$600	$2,000
W-2 codes for OB3	N/A	"TP" (tips), "TT" (overtime)
PFML (varies by state)	See state law	See state law

Conclusion

While many of these rules look daunting, they also present an opportunity for organizations to refine processes, increase transparency with employees, and support long-term workforce planning. By proactively updating systems for new wage ceilings, ensuring accurate tip-and-overtime segmentation, and keeping abreast of state-level PFML expansions, payroll teams can approach 2026 with confidence rather than caution.

Above all, employers that adopt robust monitoring tools may reduce the likelihood of year-end discrepancies. In a world where employee mobility, complex benefits, and digital pay methods are becoming the norm, these essential steps will prepare you not only for the upcoming filing season, but also for the next wave of regulatory shifts that inevitably lie ahead.

Related resources:

For additional related resources and information, see the 2025 Payroll Year-End Report and Checklist prepared jointly by KPMG Employment Tax and Bloomberg Tax & Accounting.

For more year-end (and other) communications and resources, explore the KPMG Employment Tax practice website. To learn more about the KPMG Global Mobility Services practice, please visit read.kpmg.us/GlobalMobilityServices.

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