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Tax changes for overtime and tips payroll implications

No tax on overtime

For tax years 2025 through 2028, individuals receiving qualified overtime compensation can deduct the excess pay above their regular rate—the "half" portion of "time-and-a-half" compensation required by the Fair Labor Standards Act (FLSA). This deduction applies to amounts reported on Form W-2, Form 1099, or other specified statements.

Key details

- Maximum annual deduction: **$12,500 ($25,000 for joint filers)**
- Deduction phases out for taxpayers with modified adjusted gross income over **$150,000 ($300,000 for joint filers)**
- FICA taxes remain applicable

Many companies face challenges in calculating the FLSA premium pay, particularly in states where overtime pay exceeds time-and-a-half or for union employees. As a result, recalculations are necessary to determine the premium portion.

2025 reporting for overtime

- Form W-2, Form 941, and other payroll return forms remain unchanged for the 2025 tax year.
- Federal income tax withholding tables have not been updated for 2025.
- Employers should continue current reporting and withholding procedures.

Although there's no IRS requirement to report the overtime deduction on the 2025 W-2, employees will need this information for their personal tax returns. Many employers are proactively planning to provide this information to employees at year-end, ahead of the 2026 reporting requirement. Further IRS guidance is expected in November.

No tax on tips

For tax years 2025 through 2028, employees and self-employed individuals can deduct qualified tips received in occupations listed by the IRS as customarily tipped (as of December 31, 2024). Qualified tips include voluntary cash or charged tips from customers or through tip sharing, reported on Form W-2, Form 1099, or Form 4137.

Key details

- Maximum annual deduction: **$25,000** (capped at net income from the relevant trade or business for self-employed individuals)
- Deduction phases out for taxpayers with modified adjusted gross income over **$150,000 ($300,000 for joint filers)**

The IRS has identified occupations that "customarily and regularly" receive tips. For tax year 2025, transition relief is provided to payers regarding the new reporting requirements. Employees can still claim the exemption on their personal tax returns, regardless of employer reporting.

For additional resources on One Big Beautiful Bill (OB3), check out the employment tax insights.

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