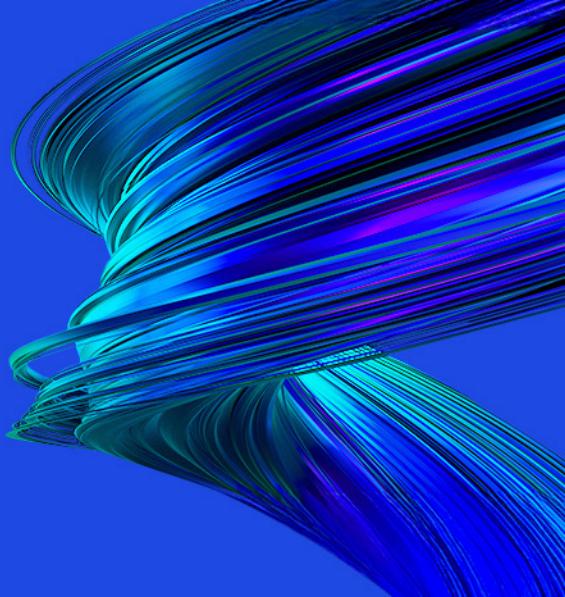


Payroll Insights

Employment tax news to guide you now and for the future

January 2026



John's fresh take: A Look Back at 2025 and What's Ahead in 2026

As we close the books on 2025, it's clear that this has been a landmark year for employment tax. The passage and implementation of the One Big Beautiful Bill Act (OBBBA) dominated our focus, introducing sweeping changes that will continue to reshape the payroll landscape for years to come.

Looking back, 2025 was the year of adaptation. We started by navigating the long tail of the Employee Retention Credit (ERC) claim resolutions and the ever-present challenges of multi-state withholding in a remote-first world. However, those ongoing issues were quickly overshadowed by the passage and implementation of OBBBA. The last few months have been spent reacting to periodic IRS guidance. In accordance with the option in the OBBBA for a transition relief period, the IRS refrained from changing 2025 reporting requirements to avoid a chaotic filing season, providing a collective sigh of relief for employers. However, this relief applies to 2025 only, and employers continue to take time out of 2025 year-end responsibilities to analyze their current data and software abilities to be compliant with reporting in 2026. By year-end, guidance like Notice 2025-69 put the onus on employees to make a "reasonable effort" to claim their credits, while employers were strongly encouraged to provide the most accurate data possible in some manner, such as a statement to employees or in Box 14 of Form W-2 *Wage and Tax Statement*.

At the same time, states began reacting to OBBBA, creating a more complex compliance map for employers. For example, while Rhode Island and Colorado explicitly decoupled from specific OBBBA provisions, Iowa, which generally conforms to federal changes, must still issue its own updated tables and guidance to implement them at the state level. In an emerging trend, Ohio is pursuing a completely separate path of tax reform by moving to a flat tax. All these actions require separate attention from employers, illustrating the growing complexity of the state tax landscape.

So, what does this all mean for 2026? If 2025 was about reaction, 2026 will be the year of proactive implementation. The transition period will be over. The draft 2026 Form W-2 includes new codes for qualified tips and overtime in Box 12, and OBBBA does not provide for, nor has the IRS indicated that there will be any relief from calculating qualified overtime premiums or tip credits (discussed in detail in prior editions of *Payroll Insights*) and reporting it on the 2026 Form W-2. The time for stop-gap measures and good-faith estimates will end, and the need for robust, systemic solutions is here.

Key areas of focus for the year ahead will include:

- OT Wage Breakout: Are you ready to breakout OT wages reporting that are eligible for “no tax on overtime” and map those amounts for reporting on the 2026 Form W-2?
- System Updates: Have you confirmed with your HRIS and payroll vendors that they are prepared to handle the 2026 Form W-2 reporting and separate tracking of qualified compensation?
- State-Level Divergence: With states like Ohio, Colorado, and Rhode Island adjusting their own tax structures, how will you manage the increasing divergence between federal and state employment tax laws?
- Retirement and Benefit Changes: With the increases in contribution limits for retirement plans and HSAs for 2026, are your systems and employee communications ready for these updates?
- The Rise of E-Filing and E-Payments: The push to phase out paper checks for employer refunds and mandate electronic filing, as seen in New Mexico, is a trend that will only accelerate. These changes will require process adjustments for many organizations.

The central theme for 2026 is embedding the changes of 2025 into daily operations. The groundwork has been laid, and now it's time to build the framework for the new era of payroll compliance.

Federal updates



Draft 2026 Form 941 and Instructions Released

The IRS released draft [Form 941](#), *Employer's Quarterly Federal Tax Return*, and [instructions](#) for tax year 2026. The draft incorporates:

- Direct Deposit for Refunds: The form will include additional spaces on Line 15 for employers to enter bank account information to receive refunds via direct deposit. However, employers will still have the option to apply overpayments to their next return. The IRS noted that if a direct deposit is rejected, a paper check will be mailed instead.
- New Aggregate Filer Identification: Aggregate filers will be required to check a box identifying their filer type. The options include Section 3504 agents (e.g., common pay agent), Certified Professional Employer Organizations (CPEOs), and “other third party” (such as non-certified PEOs).

Final 2025 Form 943 and Instructions Released

The IRS released the final Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*, and [instructions](#).

Form 943 incorporates many of the same changes seen on the draft 2026 Form 941, including additional spaces for direct deposit bank account information for tax refunds and the new aggregate filer identification.

Additionally, taxpayers can now electronically access their Form 943 return transcripts for 2023 and subsequent years through an IRS business tax account, and Form 943-X can now be filed electronically.

Final 2026 Forms W-4 and W-4P Released

The IRS released the final versions of the 2026 [Form W-4](#), *Employee's Withholding Certificate*, and [Form W-4P](#), *Withholding Certificate for Periodic Pension or Annuity Payments*.

Key updates to the forms include:

- OBBBA-Related Changes: The 2026 Form W-4 now features an expanded deductions worksheet that begins with the new deductions for qualified tip and overtime income, as introduced by the OBBBA.
- Updated Tax Credits: The credit for a qualifying child under age 17 has increased to \$2,200 (up from \$2,000).

- Form W-4P now includes a separate Step 3(c) specifically for tax credits other than the dependent credit.
- No Withholding Option on Form W-4P: A new checkbox has been added to Form W-4P to allow recipients to request no withholding, which is equivalent to the option to claim exemption from withholding on the standard Form W-4.
- Finalized Amounts: Placeholders from draft versions have been filled in, including the final 2026 standard deduction amounts, thresholds for itemized deduction limitations, and the multiple jobs tax tables attached to Form W-4.

Final 2026 Withholding Tables and the Impact of OBBBA (Publication 15-T)

The IRS released the final version of [Publication 15-T, Federal Income Tax Withholding Methods](#), for 2026. This publication provides the official computational methods, including tax tables and percentage method charts, that employers should use to determine the correct amount of federal income tax to withhold from employees' wages.

The 2026 version incorporates the updated tax rates and income thresholds for the year. A key clarification in this final release is its reference to [Notice 2025-62](#). This is important because while the new OBBBA provisions allow employees to take deductions for qualified tip and overtime income, these deductions do *not* change the amount of income subject to federal income tax *withholding*. If an employee would like to account for the potential credit in their income tax withholding, they should follow the instructions for the [2026 Form W-4, Employee's Withholding Certificate](#), and submit it to the employer to adjust their Form W-4 elections accordingly. Employers should continue to calculate withholding based on gross wages before these employee-level deductions.

Draft 2026 Fringe Benefit Guide (Publication 15-B)

The IRS released its draft 2026 guide to fringe benefits ([Publication 15-B](#)), highlighting several key updates and dollar limits for the year.

- Health FSA and Dependent Care: The contribution limit for a health flexible spending arrangement (FSA) increased to \$3,400 for 2026. The annual exclusion for dependent care assistance (DCAP) increased to \$7,500 (\$3,750 for married filing separately).
- Commuting and Parking: For 2026, the monthly exclusion for qualified parking is \$340, and the combined monthly limit for commuter highway vehicle transportation and transit passes is also \$340.
- Educational Assistance: The OBBBA has permanently extended the \$5,250 exclusion introduced in the Tax Cuts and Jobs Act for employer-provided educational assistance, which includes payments of principal or interest on an employee's qualified education loan.
- Adoption Assistance: The maximum amount that can be excluded from an employee's gross income for qualified adoption expenses is \$17,670 for 2026.
- QSEHRA: For 2026, the total amount of payments and reimbursements for a qualified small employer health reimbursement arrangement (QSEHRA) cannot exceed \$6,450 for self-only coverage or \$13,100 for family coverage.
- Eliminated Exclusions: The OBBBA permanently eliminates the income exclusion for qualified moving expense reimbursements (except for active-duty military and certain intelligence community employees) and qualified bicycle commuting reimbursements.
- Employer Meal Deduction: For amounts paid or incurred after 2025, the employer deduction for expenses associated with providing food and beverages through an on-site eating facility or for the convenience of the employer is eliminated. However, the value of these meals may still be excludable from the employee's income as a de minimis fringe benefit.

Final 2025 Form 940 Released

The IRS released the final 2025 [Form 940](#), *Employer's Annual Federal Unemployment (FUTA) Tax Return*, and its [instructions](#). The filing due date for the 2025 Form 940 is February 2, 2026; however, employers who deposited all their FUTA tax when it was due have until February 10, 2026, to file.

A key change to Form 940 is the addition of a box labeled "Aggregate Return Filers Only." This box is for use by agents of home care service recipients (approved by the IRS under Internal Revenue Section 3504 via Form 2678) and Certified Professional Employer Organizations (CPEOs). These aggregate filers should also complete and attach Schedule R (Form 940). The accompanying Schedule A (Form 940) is required for employers paying FUTA-subject wages in multiple states and calculate FUTA credit reductions for wages paid in California and the U.S. Virgin Islands.

Final Forms for Nonresident Alien Withholding (Forms 1042 and 1042-S)

The IRS finalized forms used for reporting income paid to nonresidents for the upcoming filing season. The 2025 [Form 1042](#), *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, includes new lines (71a-d) to allow filers to receive refunds via direct deposit into a U.S. financial institution.

[Form 1042-S](#), *Foreign Person's U.S. Source Income Subject to Withholding*, has a significant change. Withholding agents should include a Chapter 3 exemption code on the form any time the withholding rate is less than the statutory 30% rate, not just when the rate is zero. This will require more detailed reporting for payments subject to a reduced rate of withholding by income tax treaties.

IRS Releases 2026 Tables for Federal Tax Levy Exemptions

The IRS issued the 2026 version of [Publication 1494](#), which contains the official tables for determining the amount of an employee's income that is exempt from a federal tax levy.

Employers should use these tables to calculate the protected portion of an employee's pay when they receive an IRS Form 668-W, *Notice of Levy on Wages, Salary, or Other Income*. The specific exempt amount is based on the employee's filing status and the number of dependents claimed on the levy paperwork.

State and local updates



District of Columbia Amends Tipped Wage Law

The District of Columbia enacted legislation ([Act 26-146](#)) that significantly alters the future of its tipped minimum wage. This new law repeals the District's 2022 voter-approved initiative, which would have required the tipped wage to increase by \$2 annually until it matched the standard minimum wage in 2027.

Under the new law:

- The planned increase of the tipped wage from \$10 to \$12 per hour, which was scheduled for 2025, has been officially cancelled.
- Instead of eventually matching the standard minimum wage, the tipped wage will now be calculated as a percentage of the non-tipped rate. This begins on July 1, 2026, with the percentage gradually increasing until it reaches 75% on July 1, 2034.
- Effective January 1, 2026, employers must provide more detailed pay stubs. Pay statements must now separately list an employee's base wages, tips, commissions, bonuses, and any service charges they receive.

Indiana Releases Detailed 2026 Withholding Guidance (Departmental Notice #1)

The Indiana Department of Revenue issued [Departmental Notice #1](#), effective January 1, 2026.

The state's adjusted gross income tax rate is set at 2.95% for 2026. The applicable county tax rate is determined by an employee's Indiana county of residence as of January 1, 2026; for out-of-state employees, the rate is based on their principal county of work within Indiana.

To determine the amount of taxable income, employers must deduct specific exemption amounts from the employee's gross pay. The annual exemption values are:

- \$1,000 for each personal and dependent exemption claimed.
- An additional \$1,500 for each qualifying dependent claimed.
- An additional \$3,000 for a qualifying adopted child.

The notice also clarifies that for nonresidents, withholding should not be required if the employee is expected to work in Indiana for 30 days or less during the calendar year. However, if the employee works more than 30 days, the employer should begin withholding and may "increase withholding on that employee in any manner reasonably intended to make up for the tax not previously withheld."

Massachusetts Drafts 2026 Withholding Changes for High-Earner Surtax

The Massachusetts Department of Revenue released its draft [withholding tables](#) for 2026, which includes an important adjustment to the state's surtax on high earners.

The proposed update increases the annual income threshold for the 4% surtax to \$1,107,950, up from \$1,083,150. Any wages earned above this new threshold will be subject to the standard 5% tax plus the 4% surtax.

Montana Updates Withholding Method and Tables for 2026

The Montana [Department of Revenue](#) released its updated [Employer and Information Agent Guide](#), along with a revised [Form MW-4, Montana Employee's Withholding and Exemption Certificate](#), to reflect significant changes to the state's income tax withholding calculations, effective January 1, 2026.

Driven by House Bill 337 from the 2025 legislative session, the new method for calculating wage withholding now more closely resembles the federal method and no longer uses Montana-specific allowances.

Montana Key Legislative Changes:

- New Tax Rates and Brackets: The highest marginal tax rate is reduced from 5.9% to 5.65%. The lower 4.7% rate now applies to income up to \$95,000 for joint filers and \$47,500 for single filers.
- New Calculation Method: The withholding calculation will now rely on the federal standard deduction amount for an employee's filing status, rather than the previous system of Montana personal and dependent exemptions.
- Employee Options: Employees can still use Form MW-4 to designate an additional amount to be withheld from their paychecks.

Ohio Municipal and School District Tax Changes

Voters in numerous Ohio jurisdictions approved changes to local income taxes, most of which take effect on January 1, 2026. Employers should review the tax rates for all locations where they have employees to ensure correct local tax withholding.

Employees' wages are generally subject to Ohio municipal income tax withholding in the jurisdiction in which they perform services, with certain de minimis exceptions. Employees are generally subject to school district income tax withholding based on their residence.

Recent municipal Rate Increases Include:

- Bowling Green: to 2.15%
- Circleville: to 2.5%
- Fort Recovery: to 1.5%
- Gallipolis: to 1.5%
- Sidney: to 1.75%
- Upper Sandusky: to 1.75% (effective Dec. 17, 2025)

Several school districts, including Kings Local, Tiffin City, and Trimble Local, also enacted new income taxes.

Ohio provides a database of current [local income tax rates](#) that can be referenced once the increases go into effect.

Oregon: Statewide Transit Tax Increase on Hold Pending Voter Referendum

The Oregon Department of Revenue directed employers to postpone the implementation of an increase to the statewide transit tax that was scheduled to take effect in 2026.

Although [House Bill 3991](#) was signed into law to double the tax rate from 0.1% to 0.2% for calendar years 2026 and 2027, the legislative change has been challenged by a voter referendum initiative. As the state validates signatures for this initiative, employers are advised to continue withholding the transit tax at the current 0.1% rate.

If the measure is placed on the ballot, the tax rate will stay at 0.1% until voters decide on the increase.



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