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WHAT EMPLOYERS NEED TO KNOW ABOUT NO TAX ON OVERTIME

The One Big Beautiful Bill Act, signed into law on July 4, 2025, introduced a temporary federal income tax deduction for "qualified overtime compensation." Under this provision, eligible employees can deduct a capped amount of their overtime pay from their federal income taxes. However, it is the employer that must track and report the necessary information.

What Can Be Deducted?

The deduction does not apply to *all* overtime compensation. It only applies to the premium portion of overtime required under the FLSA. Under the FLSA, non-exempt employees who work more than 40 hours in a workweek must be paid at a rate of time and one-half (1.5 times) their regular rate. The deduction applies only to the extra *half*—the premium paid *in excess* of the regular rate.

- Example: If an employee's regular rate is $20/hour, the FLSA overtime rate is $30/hour. Only the $10/hour premium qualifies for the deduction. The regular $20/hour portion of that pay is not deductible.

Importantly, any additional overtime premium required by either state law or a collective bargaining agreement or voluntarily agreed to by the employer (e.g., double time on holidays) does not qualify for the federal income tax deduction.

Employer Reporting

An employer's payroll system must be updated to segregate and track the specific premium amount of FLSA-required overtime so that overtime premium information can be reported properly.

The new law is retroactive to January 1, 2025, but the IRS acknowledges that system updates take time. Therefore, the IRS has issued guidance providing penalty relief for the 2025 tax year for employers who are unable to file returns showing the new separate accounting.

Because new forms have not been finalized, employers must provide employees with the total qualified overtime compensation by a "reasonable method," as defined by the U.S. Secretary of the Treasury, such as reporting the amount in Box 14 of the Form W-2; providing

a separate year-end statement; or making the information available through an employee online portal.

This transition penalty relief will not be available for the 2026 tax year and beyond (the overtime deduction is currently scheduled to sunset after 2028), so employers will be required to provide all necessary reporting. The IRS has released a draft W-2 indicating that the total amount of qualified overtime compensation must be reported in Box 12 using a new, specific code (i.e., draft code "TT"), although this draft is subject to change before it is finalized. Employers should immediately begin working with their payroll provider (or internal team) to confirm that they have everything in place to handle this new mandatory W-2 field for the 2026 tax year.

Educate Employees (Carefully)

Employees will undoubtedly have questions, especially as their paystubs or W-2s begin to look different. Employees with questions about claiming the deduction or assessing their ultimate tax liability should be directed to their own tax professionals. The employer's sole obligation is to properly identify and report the qualified overtime amount on the employee's W-2.

Classification Risk

The new tax benefit potentially makes the value of being a non-exempt, overtime-eligible employee more financially advantageous. Therefore, employers should perform an audit of their exempt classifications. A misclassification that leads to an employee missing out on this tax-advantaged income could heighten the risk of a lawsuit under the FLSA.

The new "No Tax on Overtime" rule is a complex addition to the wage and hour landscape. As always, **O'Neil Cannon** is here for you. We encourage you to reach out with any labor and employment questions, concerns, or legal issues you may have.