LEGALLY SPEAKING

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Taft/


No Tax on Overtime?
Preparing Your Payroll for the New Deductions.

On November 21, 2025, the IRS released Notice 2025-69 (see here), providing essential transition-year guidance for the new federal income tax deductions for qualified overtime compensation created under the One, Big, Beautiful Bill Act (OBBBA). Although the deductions apply to individual workers, the rules have immediate consequences for employers' payroll operations and employee communications beginning with the 2025 tax year.

New Deductions for Tips and Overtime

The OBBBA adds a new deduction for qualified overtime compensation under Internal Revenue Code § 225. (It also adds a deduction for employees who receive "qualified tips" under IRC § 224, not addressed here.) This deduction applies to tax years beginning after December 31, 2024, and before January 1, 2029. Employees may deduct up to $12,500 per individual (or $25,000 for joint filers) for qualified overtime compensation, limited to the portion of overtime pay **required under the Fair Labor Standards Act** (FLSA) and also subject to employee income limitations.

Understanding what is and is not required by the FLSA is important to understanding the deduction. In general, the FLSA only applies to non-exempt employees and requires that hours worked in excess of 40 per workweek be paid at 1.5 times ("time-and-a-half") the employee's regular rate. In that instance, the employee would only be eligible for a deduction of the "half-time" amount paid for any overtime work, or one-third of the hourly overtime rate.

Employers should note that the new deduction is **not** available for employer-sponsored rates that exceed FLSA requirements (even if they are internally called "overtime" by the company), such as triple-time pay for holidays, double-time pay for weekends, and the like. In addition to any increase in the overtime calculation caused by the above, PTO or vacation pay as hours worked is not deductible by the employee. Such wage multipliers may be required by a policy, a collective bargaining agreement, or some state laws, but they are only deductible under the new rule up to the amount actually mandated by federal wage-hour law.

For example, if an employer pays "overtime" at a double-time rate (*i.e.*, two times the regular rate) and the pay statement shows a single, aggregate dollar amount for that overtime, the employee would calculate the qualified overtime deduction by dividing the aggregate overtime amount by four, again reflecting only the FLSA-required half-time portion.

Not surprisingly, calculating the deduction, especially in a collective bargaining setting, can be complicated. Employees confused about what wages actually qualify for their new individual deduction should consult an accountant. As always, employers are cautioned against giving employees tax advice.

No Immediate Form W-2 or 1099 Changes for 2025

The IRS confirms that all federal wage-reporting forms for 2025 will remain unchanged. Employers will not yet be required to separately report qualified overtime amounts on Forms W-2 or 1099. The Notice allows employees to use supporting materials such as logs and wage statements to identify qualifying overtime. Workers claiming the overtime deduction must also make a reasonable effort to confirm that they were eligible under the FLSA for overtime, which may include requesting information from their employer.

Documenting Deductible Overtime Amounts

While 2025 serves as a transition year, employers still need to maintain accurate records of reported overtime hours and overtime premiums. These records will support an employee’s deduction calculations and will become essential once the expanded reporting requirements take effect for the 2026 tax year. Employers may wish to begin evaluating whether their payroll systems can accommodate the new 2026 reporting fields, which will include separate accounting for qualified overtime amounts.

Planning Ahead for 2026 and Beyond

Beginning with periods after December 31, 2025, employers and other payors will be required to separately account for qualified overtime compensation on information returns and statements under the revised Code provision, once the IRS updates the relevant forms. The employer should use the remainder of 2025 to:

- Review whether internal systems can track FLSA-required overtime premiums separate from other non-FLSA pay multipliers.
- Audit your workforce to ensure each employee is properly exempt from overtime before an employee brings an action for misclassification. Merely paying a weekly "salary" does not exempt an employee.
- Monitor forthcoming additional IRS guidance and form revisions for the 2026 tax year.

Taking these steps now will support employees seeking to claim the new deduction and help ensure employer compliance as the OBBBA reporting regime phases in.

For more information on this and other labor and employment law issues, including NLRB, EEOC, OSHA, and DOL matters, contact Bob Dunlevey or Marc Fleischauer, Board Certified Labor and Employment Law Specialists at Taft Law, at (937) 228-2838 or via rdunlevey@taftlaw.com or mfleischauer@taftlaw.com.

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