H.R. 1 Reduces Federal Taxes on Overtime and Tips

Presented for thread

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H.R.1—The One Big Beautiful Bill Act (OBBBA)

Signed into law July 4, 2025.

Immediate Attention for Employers:

1. New above-the-line deduction for **qualified tip income**
2. New above-the-line deduction for **qualified overtime compensation**

Takes effect starting with the 2025 tax year. Applies to 2025–2028 tax years only.

"No Tax on Overtime"

Deduction for Federally Mandated Overtime Compensation

Section 70202 of the Act allows employees to deduct from federal taxable income up to $12,500* in overtime compensation that is paid pursuant to the Fair Labor Standards Act.

*$25,000 for joint filers

This deduction is limited in scope but may prompt employers to rethink how overtime is classified and compensated.

Qualified Overtime Compensation

Deduction applies only to overtime required under Section 7 of the FLSA (i.e., 1.5x pay for hours over 40 per week).

Deduction applies only to the overtime premium, not the regular wage amount.

Does not apply to:

- Overtime required only by state law (e.g., California's daily overtime rules).
- Overtime paid voluntarily under employer policy or collective bargaining agreements.
- Payments already claimed as qualified tips.

Federal and State Overtime Differences

"Qualified Overtime" is defined as overtime compensation premium paid in accordance with the Fair Labor Standards Act

FLSA mandates overtime premiums after 40 hours of work per week

State laws, including Alaska, California, Colorado, Nevada and Oregon, have daily overtime requirements which are not "qualified overtime" under H.R. 1

Employers must establish procedures for separately recording FLSA weekly overtime from other types of overtime compensation

Reporting Requirements for Employers

Employers must separately report qualified overtime compensation on Form W-2 or Form 1099.

For 2025, approximations are permitted under a "reasonable method" (to be defined by the Treasury).

Compliance Risks

- With this new deduction, employers may be tempted to reengineer pay practices. However, doing so carries significant legal exposure:
  - *Example 1:* Reclassifying salaried exempt employees as nonexempt hourly employees, lowering base pay, and inflating overtime hours to maintain prior salary levels. This would violate the if hours are not actually worked and accurately tracked.
  - *Example 2*: Reducing regular hourly rates for nonexempt employees while creating artificial overtime (e.g., setting an internal 30-hour threshold or applying double-time bonuses). This is disallowed, as only FLSA-mandated overtime pay qualifies for the deduction.
- The Treasury is authorized to issue regulations preventing abuse and wage reclassification. Employers who attempt to engineer "deductible overtime" without strict compliance with upcoming regulations will face regulatory scrutiny and possible penalties.

"No Tax on Tips"

Tax Deduction for Employees Receiving Qualified Tip Income

Section 70201 of the Act allows certain employees to deduct up to $25,000 annually in qualifying tip income.

The deduction is intended to benefit hospitality, restaurant and service industry workers, but its implementation raises numerous legal and compliance considerations for employers.

Key Requirements for Tip Deductions

- Qualified tips must:
  - be voluntarily paid by the customer (not mandatory service charges or automatically added gratuities) without negotiation
  - be paid in cash, by credit card, or through valid tip-sharing arrangements, and
  - be received in a qualifying occupation that customarily and regularly received tips as of December 31, 2024.

Key Requirements for Tip Deductions

- The Treasury must publish a definitive list of qualifying occupations by October 2, 2025
- Excluded Occupations: Employees in law, accounting, finance, consulting, performing arts, and similar professions are categorically excluded from eligibility.
- Eligibility Cap: Deduction phases out beginning at $150,000 in modified AGI ($300,000 for joint returns).

Reporting Requirements for Employers

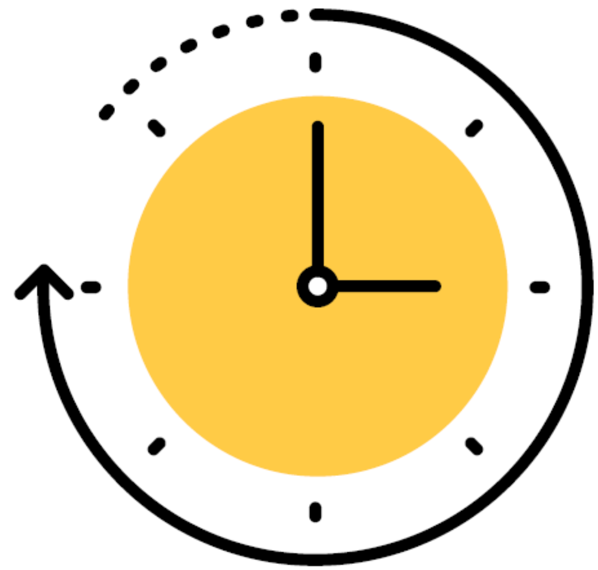
- Employers must report:
  - total cash tips received by the employee on Form W-2 or Form1099; and
  - the employee’s qualifying occupation (2025 approximations allowed, subject to Treasury guidance).

Risk Considerations for Employers

- Mischaracterization of wages as tips to secure a tax advantage may trigger IRS enforcement or wage-hour liability.
- Employers may consider changes to tip pooling or customer-facing tipping practices, but must:
  - remain compliant with FLSA tip pool rules, including exclusion of managers and supervisors,
  - avoid coercing tipping in non-traditional settings where it was not previously customary,
  - ensure 100% tip reporting is enforced among employees.
- Until the Treasury issues regulations and the occupation list, employers should avoid restructuring wages to exploit this provision.

Practical Employer Guidance

- The “no tax on tips” and “no tax on overtime” provisions will likely be popular with employees and heavily publicized during the 2025 W-2 season.
- But for employers, the changes bring regulatory complexity, legal risk, and potential downstream litigation.



What Has Not Changed?

H.R. 1 and the upcoming regulations affect federal taxes paid by employees only.

Social Security, Medicare, and Unemployment taxes are not affected and remain in place.

State and local income taxes on overtime and tips must still be paid.

What Should Employers Do Now?

- Do not alter compensation structures prematurely.
- Wait for Treasury regulations, especially the occupational list for tip eligibility.
- Ensure accurate wage and hour records.
- All overtime-eligible employees must have their hours and regular rates carefully documented.
- Audit tip pool arrangements and ensure FLSA compliance.
- Exclude ineligible participants, properly allocate tips, and enforce reporting discipline.
- Prepare to update payroll systems.
- New W-2 fields for tip and overtime breakdowns will require reconfiguration.

Questions?

Thanks for your attendance and attention!

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