



Payroll tax implications of new tax breaks on tips and overtime

Before the One Big Beautiful Bill Act (OBBBA), tip income and overtime income were fully taxable for federal income tax purposes. The new law changes that.

Tip income deduction

For 2025–2028, the OBBBA creates a new temporary federal income tax deduction that can offset up to \$25,000 of annual qualified tip income. It begins to phase out when modified adjusted gross income (MAGI) is more than \$150,000 (\$300,000 for married joint filers).

The deduction is available if a worker receives qualified tips in an occupation that's designated by the IRS as one where tips are customary. However, the U.S. Treasury Department recently released a draft list of occupations it proposes to receive the tax break and there are some surprising jobs on the list, including plumbers, electricians, home heating / air conditioning mechanics and installers, digital content creators, and home movers.

Employees and self-employed individuals who work in certain trades or businesses are ineligible for the tip deduction. These include health, law, accounting, financial services, investment management and more.

Qualified tips can be paid by customers in cash or with credit cards or given to workers through tip-sharing arrangements. The deduction can be claimed whether the worker itemizes or not.

Overtime income deduction

For 2025–2028, the OBBBA creates another new federal income tax deduction that can offset up to \$12,500 of qualified overtime income each year or up to \$25,000 for a married joint-filer. It begins to phase out when MAGI is more than \$150,000 (\$300,000 for married joint filers). The limited overtime deduction can be claimed whether or not workers itemize deductions on their tax returns.

Qualified overtime income means overtime compensation paid to a worker as mandated under Section 7 of the Fair Labor Standards Act (FLSA). It requires time-and-a-half overtime pay except for certain exempt workers. If a worker earns time-and-a-half for overtime, only the extra half constitutes qualified overtime income.

Qualified overtime income doesn't include overtime premiums that aren't required by Section 7 of the FLSA, such as overtime premiums required under state laws or overtime premiums pursuant to contracts such as union-negotiated collective bargaining agreements. Qualified overtime income also doesn't include any tip income.

Payroll tax implications

While you may have heard the new tax breaks described as “no tax on tips” and “no tax on overtime,” they're actually limited, temporary federal income tax deductions as opposed to income exclusions. Therefore, income tax may apply to some of your wages and federal payroll taxes still apply to qualified tip income and qualified overtime income. In addition, applicable federal income tax withholding rules still apply. And tip income and overtime income may still be fully taxable for state and local income tax purposes.

The real issue for employers and payroll management firms is reporting qualified tip income and qualified overtime income amounts so eligible workers can claim their rightful federal income tax deductions.

Reporting details

The tip deduction is allowed to both employees and self-employed individuals. Qualified tip income amounts must be reported on Form W-2, Form 1099-NEC, or another specified information return or statement that's furnished to both the worker and the IRS.

Qualified overtime income amounts must be reported to workers on Form W-2 or another specified information return or statement that's furnished to both the worker and the IRS.

IRS announcement about information returns and withholding tables

The IRS recently announced that for tax year 2025, there will be no OBBBA-related changes to federal information returns for individuals, federal payroll tax returns or federal income tax withholding tables. So, Form W-2, Forms 1099, Form 941, and other payroll-related forms and returns won't be changed. The IRS stated that "these decisions are intended to avoid disruptions during the tax filing season and to give the IRS, business and tax professionals enough time to implement the changes effectively."

Employers and payroll management firms are advised to begin tracking qualified tip income and qualified overtime income immediately and to implement procedures to retroactively track qualified tip and qualified overtime income amounts that were paid before July 4, 2025, when the OBBBA became law. The IRS is expected to provide transition relief for tax year 2025 and update forms for tax year 2026. Contact us with any questions.

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