

## Issues Related to the “No Tax On Overtime” Provision

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Practice Area: Labor and Employment & Government Law

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Within the One Big Beautiful Bill Act, signed into law on July 4, 2025, is the new “No Tax on Overtime” rule that may positively impact many hourly workers as it relates to their payment of federal taxes starting in 2025. However, this change in the law also presents new challenges for employers and ambiguities that will need to be addressed.

For starters, the new overtime provision is limited to overtime wages paid by employers to employees qualifying for Section 7 overtime under the Fair Labor Standards Act of 1938 (FLSA). The provision does not apply to exempt employees as exempt employees do not qualify for FLSA overtime. The provision allows certain eligible employees to take a deduction for overtime wages earned pursuant to the FLSA and reported on Form W-2. Overtime applies to the overtime gained under the FLSA. It does not apply to overtime gained by other means such as overtime earned by employer policy or by provisions of a collective bargaining agreement.

Since the provision applies to overtime earned under Section 7 of the FLSA, it appears to apply to one aspect of public-sector compensatory time earned under 29 C.F.R. Section 553.22–.27, since that compensatory time is based on hours worked above the overtime threshold and thus gained under Section 7. We do not believe this law applies to 29 C.F.R. Section 553.28 “other compensatory time,” which is time earned and accrued by an employee for employment in excess of a non-statutory (that is, non-FLSA) requirement and often considered “other” compensatory time (this form of compensatory time is actually likely more common for public-sector employers). “Other compensatory time” is commonly found in many public-sector employer policies and collective bargaining agreements. However, we may need to wait for further guidance as regulations are provided later by the Department of Labor.

The new provision is effective for tax years 2025 through 2028. Unless extended, the provision will only apply for these tax years. It is written to reach back to January 1, 2025 so overtime earned prior to being signed into law will qualify and must be accounted for by the employer.

Overtime wages are still subject to federal income tax withholding, state and local tax withholding, as well as employment tax withholding, including Social Security and Medicare. Later, in preparing their federal tax return, employees will be able to exclude qualified overtime compensation from gross income for federal income tax purposes. The exclusion would be taken by the individual as an above-the-line deduction on their federal income tax return.

The rule does set limits on the amounts that can be deducted and may not apply to higher income workers. The deduction is capped at \$12,500 for single filers and \$25,000 for joint filers. It is phased out by \$100 for each \$1,000 by which the taxpayer’s modified adjusted gross income exceeds \$150,000 (\$300,000 in the case of a joint return).

For 2025, employers can approximate a separate accounting of amounts designated as overtime by any reasonable method “specified by the Secretary” in order to comply with the reporting requirements.

### **What Employers Need to Know and Consider for Now**

- **Prepare for Accurate Overtime Accounting.** The reality is most overtime occurs due to policy or other contract. This provision only applies to FLSA overtime. Therefore, employers should revisit their accounting methods to assure the distinction and be ready to separate out FLSA overtime.
- **Prepare for Accurate Compensatory Time Accounting.** Public-sector employees might earn compensatory time under both of the FLSA compensatory time concepts: traditional FLSA compensatory time under Section 553.22 - .27 and “other compensatory time” under Section 553.28. Employers must be able to account for which form of compensatory time was earned by the employee. Employers should do this any way because the rules for use and denial of compensatory time differ depending on which compensatory time was earned.
- **Prepare for a W-2 Update.** Employers will be required to report overtime wages separately on Form W-2. This could be accomplished through new Box 12 or 14 reporting. It is unlikely that reporting on Form W-2, Boxes 1, 3, and 5 would change.
- **Tax Withholding and Reporting of Employee Compensation is Still Required.** The overtime provision does not create an exclusion from income subject to withholding. Overtime wages are still subject to federal income tax withholding, state and local tax withholding, as well as employment tax withholding, including Social Security and Medicare.
- **Be Careful Not to Alter Compensation Methods That Trigger Audits and Wage & Hour Liability.** Employers may be pressured or tempted to change certain status or methods to gain advantages under the new law that creates an audit or liability. For example, changing exempt employees to hourly, reducing their pay, and then allowing a tax deduction on “overtime” (that makes up for the reduced salary), or changing hourly employees to salaried to avoid the overtime accounting may trigger a Department of Labor complaint resulting in an audit and may create liability depending on the facts of the situation.
- **Consider Preparation of a Communication to Employees.** With anticipation of guidance coming forward from the Department of Labor, and year-end questions from employees, consider preparing an informative update for your employees.

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