



## New Federal Tax Breaks on Overtime and Tips: What Employers Need to Know

*Content provided by Fisher Phillips LLP*

The 2025 federal “One Big Beautiful Bill” introduced a temporary tax benefit for tipped and hourly employees by allowing them to deduct portions of their tip and overtime income from federal taxes. This change, effective for tax years 2025 through 2028, has the potential to make hospitality and similar jobs more attractive. For employers, it presents both opportunities and new compliance obligations.

### Overview of the Tax Relief

Under the new law, eligible workers can deduct up to \$25,000 of tip income and up to \$12,500 of overtime income from their federal taxable income each year (or up to \$25,000 for married filers filing jointly). These deductions are aimed at boosting take-home pay for workers in industries with historically variable income and demanding schedules.

### Who Qualifies?

To be eligible, employees must meet the following requirements:

#### Income Limits

- Single filers: Adjusted gross income (AGI) of \$150,000 or less
- Joint filers: Combined AGI of \$300,000 or less
- These limits will be indexed for inflation starting in 2026.

#### Tip Income Deduction

- Available to employees in [customary tipped occupations](#) (i.e., servers, bartenders, hotel workers, hairstylists; see link for full list)
- Applies only to voluntary tips from customers, whether cash or charge, and includes tip-sharing arrangements. **Automatic service charges or service fees do not qualify.**
- Tips must be reported to the employer and included W-2 or 1099 to qualify.
- The maximum annual deduction for tip income is \$25,000 per individual.
- Individuals may take the standard deduction and the tip deduction on the same return.
- When filing Colorado taxes, the tip deduction can also be used to reduce an employee’s taxable income.

#### Overtime Income Deduction

- Applies only to the premium portion of overtime wages as defined under the Fair Labor Standards Act (FLSA) (i.e., the ½-time premium above the regular hourly rate for time worked beyond 40 hours in a week). Overtime pay based on non-FLSA requirements such



as a union contract or enhanced overtime from the employer are not eligible for the deduction.

- Employees must be eligible for and actually receive FLSA-compliant overtime pay.
- The maximum overtime deduction is \$12,500 per individual, or \$25,000 for married couples filing jointly.
- When filing Colorado taxes, the overtime deduction CANNOT be used to reduce an employee's taxable income.

These deductions will only apply for tax years 2025 through 2028, unless extended by Congress.

### What This Means for Employers

This tax change is likely to create a more attractive compensation environment for workers in sectors such as food service, hospitality, retail, and personal services. But it also brings new responsibilities for employers, especially in payroll and reporting.

#### 1. Increased Recruitment and Retention Advantage

These deductions could improve employee satisfaction and retention by increasing effective take-home pay, particularly for jobs with high tip or overtime potential. Employers in competitive labor markets may want to highlight these tax advantages in hiring and onboarding materials.

#### 2. Payroll System Adjustments

**Employers will need to retroactively track and report tip and overtime income separately to support employee eligibility and reporting.** This means payroll systems may require reconfiguration to:

- Isolate tip income reported for payroll purposes
- Track FLSA-defined overtime premium pay distinctly from regular wages
- Ensure W-2 forms correctly reflect these categories

#### 3. More Complex Year-End Reporting

Form W-2s will need to clearly identify deductible amounts (tip income and OT premium pay) to help employees claim the appropriate deductions. Employers should prepare for potential updates to IRS W-2 instructions and software integration challenges.

#### 4. Staff Training for HR and Payroll Teams

Human resources and payroll staff will need guidance on the eligibility criteria and reporting requirements. Employers may also face an increase in employee inquiries as workers look to understand how these deductions affect their taxes.



## Action Items for Employers

1. **Evaluate Payroll System Capabilities:** Work with your payroll provider or internal team to ensure systems can identify, track, and report qualifying tip and overtime income.
2. **Plan for W-2 Modifications:** Anticipate necessary changes to year-end reporting and W-2 disclosures to support employee deductions.
3. **Educate Staff and Workers:** Prepare HR and payroll teams to communicate the benefit clearly and help employees understand how to take advantage of the new deductions.
4. **Highlight in Recruiting Materials:** Emphasize these deductions in job postings and candidate conversations to help attract and retain workers in a tight labor market.