Deloitte.

TAX
NEWS & VIEWS PODCAST

Episode - Overtime and tips: Employer and employee tax essentials

Host
Carrie Falkenhayn, Tax Partner, Deloitte Tax LLP

Speakers
Elizabeth Karcher, Tax Partner, Deloitte Tax LLP
Scott A. Walter, Tax Partner, Deloitte Tax LLP

Carrie Falkenhayn: From Deloitte Tax, welcome to the Tax News and Views podcast series. In this series, we talk to specialists from Deloitte about the latest business issues and developments. I'm Carrie Falkenhayn, your host for Tax News and Views. Today, we are talking about certain provisions of the One Big Beautiful Bill Act, which I like to call OB3. We all remember it was signed into law July 4th, 2025, and we're going to focus specifically on the employment tax impacts. Our listeners have likely heard about changes to the taxation of overtime pay and tips, and on this podcast, we will talk about what those changes mean to both individuals and their employers. Joining me are two specialists from Deloitte's Global Employer Services Practice, Scott Walter and Elizabeth Karcher. Welcome, both of you, to the podcast, and Elizabeth, let's get us started. Can you tell me a little bit about these new overtime and TIP provisions under OB3?

Elizabeth Karcher: Thanks, Carrie, it's wonderful to be here. The overtime and tip provisions that came out of OB3 were a really big campaign promise from the President. There was a lot of, discussion during the campaign trail of taking away tax on tips and tax on overtime. The actual fine print of how that worked out in OB3 is that although tax is still applied at withholding for tips and for overtime in the same way it always has been. Individuals can now take an income tax deduction on their individual returns. For overtime and tips up to certain amounts. The key, when we talk about overtime, is that it's really that premium portion of overtime that is eligible for the deduction. So, for example, if somebody gets paid time and a half for the hours that they're working overtime, it's that incremental 50%, or that half time, that counts towards this deduction.

Scott A. Walter: Now, Elizabeth, just out of curiosity, you know, as we're talking about this, has there been any discussion yet at the service that you're aware of where we're talking about applying that more broadly? So, for example, employers that may pay a more generous premium. Or for employers that are governed by local state law, that may require overtime in situations above and beyond what's required under the FLSA rules.

Elizabeth Karcher: Yeah, it's a question that I think a lot of employers are grappling right now. The way OB3 was written, it specifically references qualified overtime, and it defines qualified overtime as overtime that is paid pursuant to FLSA. Broadly speaking, FLSA rules require time and a half over 40 hours in a given week. As Scott just alluded to, there are a lot of states or specific company provisions that might provide overtime that is more generous than those normal FLSA rules. At this point, there hasn't been any further guidance from the IRS and Treasury around what exactly, qualifies for qualified overtime. What's very clear is that FLSA overtime counts. What's slightly less clear at this point is how those other types of overtime would be included.

Scott A. Walter: Understood.

Carrie Falkenhayn: There's a lot here. When do these new rules take effect, Scott? I'm glad you jumped in here. Will you comment on when these rules take effect?

Scott A. Walter: Yeah, absolutely. So, the rule is, the deductions are available from 2025 to 2028, and I think one of the interesting provisions here is you've got retroactive, you know, a retroactive start date. These go back to effectively January 1st of 2025. So, that's obviously created, you know, an issue for a lot of employers that are not only trying to get their systems set up by the end of the year so they can report accurately and correctly in 2025, but, you know, this historical adjustment that they're going to have to make within payroll systems to catch up, in essence. And, you know, that's creating a lot of confusion out there in the employer space. So, you know, a little bit unique. We sometimes see these provisions become retroactive. But for the tips and overtime, you know, certainly seeing it go back to 1-125, you know, given how late we are in the year, has been an adjustment for employers. You know, that said, the IRS has released some, you know, additional clarifications, and, you know, I think we're going to talk about that in a minute. In terms of what the future holds for our clients, as they, you know, come to terms with 2025 and beyond.

Elizabeth Karcher: Yeah, Scott, I think as we think about the timing for the individual deductions, it is really important for people to understand that this is a deduction they can take starting on their 2025 return. It's not a free-for-all, though, in terms of being able to deduct every single dollar of overtime that was paid. There's a limit on the deductions of up to $12,500 for single individuals, or $25,000 if you're married filing joint. Both of those limitations, though, start to phase out, and the deduction gets a little bit smaller once you have income over certain levels. The idea being that this is really a tax benefit for people who make under certain levels, not necessarily for the high earners.

Scott A. Walter: And that's consistent with some of the campaign promises, right, Elizabeth? You know, I know initially we thought this might have broad applicability, but, you know, there's some guardrails in here to prevent individuals who are making, you know, more than, you know what the administration deemed to be, you know, sufficient to, you know, take these deductions. So, you know, I think what we're seeing here is, right, consistent with largely what was promised, you know, initially when these ideas were rolled out.

Carrie Falkenhayn: I want to go back to something you said, though, Scott. You talked about what employers need to do, and it'd be good to go deeper, right? Because this sounds like it's an individual tax deduction, so why do employers need to do anything?

Scott A. Walter: Yeah, absolutely. You know, at its heart, you're right, this is an individual deduction, right? The legislation was meant to allow individuals to deduct these amounts. So, the question that employers are asking themselves is, well, what role do I play in this? Right? And the reality is that while it is an individual deduction, employers are still responsible for a lot of the communication and the information statement reporting that goes along with this deduction. Specifically, the information reporting that allows these individuals to pick up the amounts that they're going to deduct on their returns. So part of what employers have to do here is track and report the overtime premium and the tip earnings. In years beyond 2025, meaning beginning in 2026, the IRS has released Draft Forms W-2 that show very clearly how they expect employers to report those amounts. So, you know, there is additional coding for Box 12, for qualifying tips. There is a code TP that was rolled out in 2026.

Scott A. Walter: In addition, there's a new Box 14B, where employers can indicate the Treasury-tipped occupational code, for that specific, individual and employer. For overtime purposes, there's a new code, a new Box 12 code TT, which is going to report the total amount of qualified overtime compensation. So, looking forward, in 2026, there's absolutely going to be employer reporting that goes along with this. So while nothing's going to change from a payroll tax perspective, meaning overtime and tips are still going to be fully subject, and subject to all employment taxes reportable on a W-2, subject to withholding, no different than they historically have been treated, now there is this additional reporting requirement that employers are going to have to comply with in 2026 and beyond, so that individuals can be assisted with taking the proper amount of that deduction on the return for those tips and for that overtime. And what that really means is that employers have to begin updating their payroll system to properly track and separate the overtime and the tipped earnings so that those amounts can correctly map to the W-2. And, you know, that obviously has left employers with a lot of questions of, okay, well, you know, we've got this FLSA rule that, you know, Elizabeth alluded to, but how do we actually figure out what to report? How do we figure out how to map this in our system so that it goes to the correct boxes in 2026? And that's where a lot of our clients and a lot of our employers are struggling with right now.

Elizabeth Karcher: Scott, I think that makes a lot of sense for 2026, and it seems really clear that that new Box 12 is going to kick in the more challenging year, I think, is what we're dealing with right now for 2025. The IRS said in their most recent notice that they aren't going to be penalizing employers if they do, or if they don't, or based on what they report for 2025. There's a little bit of a school of thought that that means employers don't need to do anything, and the IRS is sort of cautioning people against that by saying look, even though it's not mandatory, and we don't have this new Box 12 code set up yet for this year, we still really encourage you to think about doing some sort of reporting for your employees this year. They gave a few options in that notice and said you can provide an information statement, you can provide a letter, you can post something on a company portal. You could even put the information in box 14 of the W-2. Knowing that next year it would move from Box 14 to Box 12. I think that, that guidance makes a lot of sense in terms of making sure employees have access to the information that they're going to need. But the variety of options and ways to do that creates a decision point for employers in trying to figure out what makes the most sense for their population.

Carrie Falkenhayn: So, you mentioned the notice. Is there anything that the notice, did not address, or are we expecting additional guidance?

Elizabeth Karcher: But the notice very much did not address, any of the discussion that we've had so far around what constitutes qualified overtime whether it's FLSA, state-mandated overtime, or generous company policies, the notice was entirely silent and just used the phrase qualified overtime that was found in the original OB3 bill. They have, though, said in the notice that at some point, they plan to give more guidance for individuals in terms of how to actually claim the deduction. We know right now it's going to be an additional schedule that goes with the 1040 Schedule 1A. So, my expectation is maybe not before year-end, but at some point, between now and when the individual tax filing season opens, that we will see something else from the IRS. Whether it addresses that discussion of what's considered qualified overtime or not is a bit of a, a question mark still.

Scott A. Walter: Well, and Elizabeth, I think it's interesting to think about how we got here, right, and taking a look backwards. On August 7th, 2025, is when the IRS initially released some guidance, and that guidance was really favorable for employers, right? That guidance, in essence, said there's going to be no changes to the Forms W-2 or 941 for tax year 2025. You know, we talked, or I talked a little bit earlier about the changes that we're seeing in 2026 for those W-2s. But this initial guidance from the IRS was welcomed by employers and clients, right? Saying, oh, this is great, I don't have to do anything related to W-2s or 941s for 2025. Meaning employers and payroll providers didn't have to frantically update their systems to accommodate any new reporting, right? They were largely able, or at least directed, to kind of just do what you did last year. And we've been all patiently awaiting this additional guidance from the IRS that, you know because we're not going to have to do anything related to W-2s or 941s for 2025, how are we otherwise going to meet this requirement to communicate this information to employers in 2025? And that's where to you just, you know, to the point you just referenced, notice 2025-62 came, and that was released on November 5th. And, you know, everyone was cautiously optimistic that that was going to provide some guidance in terms of what to communicate. You know, ultimately, instead of what we got was that this is going to be a transition period, and the IRS is not going to impose penalties. So, you know, a lot of the onus, they kind of kicked back to employers and said, you know, you've got to figure this out. And they gave some options. You mentioned the Box 14. Right? You know, we've seen some other employers look at, you know, things like communications and updates within their internal systems to direct employees to specific statements. But, you know, at the end of the day, right, the initial guidance was no changes, and then this recent round of guidance we got from the IRS in terms of this notice, was in essence, just identifying 2025 as this transition year where employers wouldn't be penalized. So, you know, it's largely good for employers, but ideally we would have loved some additional information, you know, to help employers figure out exactly what to communicate to employees.

Carrie Falkenhayn: So what else are you hearing about from organizations related to these provisions? Where are they struggling, perhaps?

Elizabeth Karcher: So, organizations I've been talking to have really been kind of grappling with this idea of what they should report and how much they should beâ€¦ how much they should be giving to their employees for this year, there's a bit of a debate around if we take a, very cautious view and only report what is very clearly FLSA over time. Will we be understating amounts if the IRS later comes out and gives some guidance that's slightly more favorable to employees? I don't think any company is looking to, you know, shortchange their employees on this tax deduction.

Scott A. Walter: On the flip side, they're also hesitant to do anything else that might be considered.

Elizabeth Karcher: Too aggressive, and perhaps overstating the amounts of overtime. Interestingly, a lot of the companies I've talked to more recently, since the notice came out a couple weeks ago, have been leaning towards giving their employees information about how their overtime is calculated, where they can find it on their pay slips, and making it a bit of a do-it-yourself process to go find those pay slips and figure out the amount of overtime. And then work with their tax advisor to actually take the deduction, rather than giving a specific amount as we look forward to next year, where this becomes a little bit more formalized and goes onto the W-2, there is already a lot of, preparation taking place in terms of updating pay codes, updating pay systems, and making sure that there's some sort of automated means of being able to report this next year, so that it's not quite a manual effort again.

Scott A. Walter: You know, at this point, a lot of what I'm seeing out in the market are do-it-yourself solutions where employers are directing individuals, you know, to their pay statements, flagging where overtime and tips are separately broken out on those pay statements, and, you know, directing individual employees to work with their tax advisors. I think, you know, what clients and employers are really struggling with is it's always, you know, hard to thread that needle between helping your employees and not providing tax advice. And ultimately, as we said earlier, right, this is an individual deduction. So you want to be very careful in the type of advice you're providing to your employees, because you don't want to get sucked into providing individual income tax advice. Right? That's really best provided by an individual's tax return preparer. So it's a really fine line that, you know, employers have to straddle here to make sure that, you know, they are being compliant with the spirit of the rules while also not providing their individual employees incorrect advice. And that's why I think the do-it-yourself methodology is what a lot of employers are opting for here in 2025.

Carrie Falkenhayn: So what's next for overtime and tips, as we move forward?

Scott A. Walter: Well, you know, I think it remains to be seen how effective this is gonna be, right? Meaning, are individuals going to easily be able to take these deductions? Are they gonna be well received by individuals? Are there going to be any hurdles to taking these deductions on individual returns? Are there going to be challenges that employers face in terms of what to calculate, what to quantify, and what to include on these communications to employees? Will payroll providers be able to accurately adjust their systems to track these amounts? I think there's a lot of open questions. So, you know, when we're looking forward and thinking about this legend, thinking about this, you know, piece of tax law, right, what are the likelihood that this ever gets extended? We're just not sure. You know, we're going to kind of wait and see how this all plays out. Right now, this will be effective through 2028. So it remains to be seen, right, what the life expectancy of this will be. Will it be extended, or will it, you know, just sunset in 2028? What we do know, right, is, you know, looking in the near future, 2025 is about to close out here. W-2s are going to be due at end of January in 2026. So right now, you know, when we're thinking about the future, we're thinking about what does that 2025 W-2 process looks like? And employers have broad leeway in terms of what they're going to be allowed to do in 2025, based on IRS guidance. So, a lot of employers, I'd say most employers right now, are just laser-focused on 2025. But as soon as those W-2s get out, the new focus will be, okay, how do we begin tracking this and reporting this compensation within our system so that we can accurately map it to the 2026 W-2 based on these new fields? So for now, I think the biggest hurdle is figuring out what they're going to do for the 2025 communication process, and then that's gonna flip pretty quickly into thinking about how are these pay codes going to be identified and tracked in 2026. So that we can be compliant going forward. And, you know, we're always hopeful for additional guidance from the IRS. I think we'll probably get some, you know, we'll get some on the individual income tax side, certainly, but I'm hopeful that in 2026, we're going to see some additional guidance to employers to answer some of these questions that a lot of folks are still struggling with. Like, you know, what is included in FLSA? What happens when employers pay more than the premium? You know, some of those questions, I think we'll eventually see some guidance for. So, at this point, you know, we're telling employers, focus on 2025. And then once you get that wrapped, hopefully we'll have some additional information to report on 2026, so we can get those payroll systems updated and compliant.

Elizabeth Karcher: Yeah, I would caution people, Scott, that, you know, as you said, there is a lot of leeway for what you do this year. It's very tempting, I think, to want to do nothing, given there's no penalties. But inevitably, what is going to happen if you don't give any sort of information or data to your employees about what their qualified overtime is, you are going to get hundreds or thousands of questions come tax filing season, when employees are getting questions from their tax advisors or their tax return software. They're going to be coming back with questions about overtime. I'm really strongly recommending everyone to be proactive on this, even though we don't have those penalties. There's a lot of options in what you can do and how you can communicate this. I think the only really wrong option at this point would be to stay completely silent.

Carrie Falkenhayn: Well, thank you both for the discussion today. There's certainly a lot for employers to think about as they approach year-end, and for individuals to be able to take advantage of those provisions to the extent they're qualified. If our audience would like more, go to Deloitte.com and search on OBBBA. There's lots of guidance there. You are also welcome to search on Global Employer Services, and there you'll find some additional information about that group that Scott and Elizabeth come from, and how they might be able to help your organization. Thank you, everyone, for listening. I hope you're able to join us next time. Until then, be well, everyone!