

Blog Post

What Employers Need to Know About No Tax on Tips and No Tax on Overtime

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The “One Big Beautiful Bill Act” (OBBBA), the sweeping, comprehensive budget legislation enacted on July 4, 2025, seeks to fulfill several key campaign promises of President Donald Trump. Among those promises, the OBBBA makes good on Trump’s pledge to reduce taxes on tips and overtime for workers. Employers with tipped workers, particularly those in the hospitality and service industries, and employers with workers that receive overtime pay should be aware of how the OBBBA will impact their obligations and reporting requirements. In the coming months, the IRS is expected to provide guidance to employers regarding which occupations qualify for the deductions.

Fast Facts

- Workers who customarily and regularly receive tips can claim an above-the-line deduction for up to \$25,000 in tips from their taxable income. Businesses must report workers’ tips to the IRS on an information return (such as Form W-2 or Form 1099).
- Workers may deduct up to \$12,500 in overtime pay from their taxable income. Businesses must report workers’ qualified overtime compensation to the IRS on an information return (such as Form W-2 or Form 1099).

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- Both deductions are available in addition to the standard deduction. The deductions take effect for the 2025 tax year and are effective through the 2028 tax year.

No Tax on Tips

Under the new law, retroactively effective on earnings after January 2025, employees (and self-employed individuals) may deduct “qualified tips” from their income subject to federal income tax up to an amount of \$25,000 per year. The OBBBA defines “qualified tips” as voluntary cash tips received by an individual in an occupation that customarily and regularly received tips on or before December 31, 2024. The term “cash tips” includes both cash and charged tips and, in the case of employees, tips received under a tip pooling arrangement. Further, to be considered a “qualified tip” the cash tip must be paid voluntarily without any consequence in the event of nonpayment, not the subject of negotiation, and determined by the payor. Thus, for example, an automatic gratuity of 18% added by a restaurant to a check for a large party would not be considered a qualified tip. Importantly, workers’ tips remain subject to payroll taxes and state income taxes, where applicable. As such, employers are still responsible for the employer share of payroll taxes on qualified tips.

The Act requires the Treasury secretary, before October 2, 2025, to publish a list of occupations that “customarily and regularly received tips on or before December 31, 2024.” While not entirely clear, this limitation is likely intended to deter attempts to reclassify employees’ existing income as “qualified tips” to take advantage of the new deduction.

Notably, the deduction phases out by \$100 for each \$1,000 by which the taxpayer’s modified adjusted gross income over \$150,000 (and \$300,000 for joint filers). To claim the deduction, taxpayers must include their Social Security Number on the return

and file jointly if married (in which case both spouses must have a valid Social Security Number).

In addition, employees in a trade or business that meets the definition of a Specified Service Trade or Business (SSTB) under Section 199A of the Internal Revenue Code are not eligible for the deduction. An SSTB includes a trade or business involved in accounting, healthcare, law, actuarial science, athletics, brokerage services, consulting, financial services, the performing arts, investing or investment management, dealing in securities, partnership interests, or commodities, or a business where the principal asset is the reputation or skill of its owners or employees.

Finally, the OBBBA authorizes the Treasury secretary to prescribe additional regulations or guidance establishing additional requirements to qualify for the deduction and to prevent reclassification of income as qualified tips and to prevent abuse of the deduction.

Changes for Employers

The OBBBA does not modify the existing employer requirements for reporting income, including cash tips, to the IRS. However, the OBBBA may encourage employees to report cash tips that previously may have been undisclosed. Businesses must track and report the total amount of cash tips reported by the employee (or independent contractor) in addition to the worker's qualifying occupation on Form W-2 or 1099. Businesses also may need to separately identify the qualified tip amount on the information return. Businesses should be mindful of the distinction between voluntary tips (which count as qualified tips) and mandatory service charges (which do not). The OBBBA also includes a "transition rule," which permits the reporting party to "approximate" the amount designated as cash tips pursuant to a "reasonable method" to be specified by the Treasury secretary for 2025.

In addition, the OBBBA permanently expands the Federal Insurance Contributions Act (FICA) tip credit for the portion of payroll taxes that an employer pays on certain tips to include payroll taxes paid on tips received in connection with beauty service businesses, including barbering, hair care, nail care, esthetics, and spa treatments, where tipping is customary. Historically, the tip credit has been available only to employers in the food and beverage industries.

The OBBBA directs the IRS to update the applicable income tax withholding procedures and tax forms to reflect the tip deduction and required occupation listing.

No Tax on Overtime

Effective January 1, 2025, individuals may deduct “qualified overtime compensation” from their income subject to federal income tax up to an amount of \$12,500 (\$25,000 for joint filers).

The OBBBA defines “qualified overtime compensation” as “overtime compensation paid to an individual required under section 7 of the Fair Labor Standards Act of 1938 that is in excess of the regular rate.” This means that only the overtime premium qualifies for the deduction.

Importantly, the deduction does not apply to overtime premiums that are not “required” by Section 7 of the FLSA, including overtime premiums required under state laws (such as California’s law requiring businesses to pay daily overtime for hours worked in excess of eight in one day) or pursuant to a contract (like collective bargaining agreements). In these situations, workers would not be able to claim the deduction with respect to such overtime premiums.

Like the qualified tip deduction, the overtime deduction phases out for taxpayers with modified adjusted gross income over \$150,000 (\$300,000 for joint filers). In addition, as with the qualified tip

deduction, to claim the overtime deduction, taxpayers must include their Social Security Number on their tax return and file jointly if married. Notably, the OBBBA provides that qualified tips cannot also be claimed as qualified overtime compensation.

Changes for Employers

The OBBBA requires employers to report the total amount of qualified overtime compensation to the IRS on an information return. We expect the IRS to provide clarity regarding specific changes to W-2 and 1099 reporting requirements. Further, like the tip deduction, the overtime deduction permits the reporting party to “approximate” the amount designated as qualified overtime compensation pursuant to a “reasonable method” to be specified by the Treasury secretary for 2025.

The OBBBA directs the IRS to update the applicable income tax withholding procedures and tax forms to reflect the qualified overtime deduction.

Takeaways

The IRS is expected to issue guidance in the coming months regarding the new deductions under the OBBBA. In the meantime, employers should continue to maintain accurate records and plan ahead to ensure compliance with any new tracking and reporting requirements. In addition, employers should consult with employment counsel prior to making any changes to employee classifications or hours as a result of the new deductions.

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