Municipal Technical Advisory Service
INSTITUTE for PUBLIC SERVICE

"No Tax on Overtime" Deduction

Guidance on the Temporary Tax Deductions for Overtime Included in the One Big Beautiful Bill Act of 2025

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Executive Summary

The "No Tax on Overtime" provision is included in Section 70202 of the One Big Beautiful Bill Act which became law on July 4, 2025. It allows certain hourly employees to lower their federal income taxes on part of the overtime pay they earn through a deduction. This applies only to non-exempt employees who earn overtime under the federal Fair Labor Standards Act (FLSA). Employees can start claiming this tax deduction on their federal tax returns for tax years 2025 until it expires after the 2028 tax year.

The deduction does not apply to all overtime pay. It only applies to the extra premium portion of FLSA overtime – often referred to as the "half" in "time-and-a-half." For a simplified example, if an employee is compensated at a regular rate of $20 per hour and is paid $30 per hour for overtime, only the extra $10 per hour overtime premium may count toward the tax deduction. The $20 regular rate portion is still taxable.

Employees who claim this deduction may owe less in federal income taxes. If they do not claim it, the overtime pay is taxed like normal income. Either way, employees must still pay Social Security and Medicare taxes, as well as any state or local taxes, on all overtime pay. Those taxes are not affected by this law.

While "No Tax on Overtime" sounds all encompassing, it is not. The Act does not cover all types of overtime or extra pay. Only overtime that is required by the FLSA qualifies. Overtime paid because of state law, a labor agreement, or an employer's own policy does not qualify. Other types of pay, such as on-call pay, stand-by pay, or similar premiums, are also not eligible.

For local government employers moving forward, the key responsibility will be accurate recordkeeping. Municipalities need to clearly track and report FLSA-required overtime separately from other types of compensation. This will help ensure payroll records and year-end tax forms (i.e., W-2s, etc.) are correct and will reduce confusion for employees who may have questions about this new deduction.

Introduction

The purpose of this report is to provide practical guidance to local government employers on the employer-facing aspects of the "No Tax on Overtime" deduction. Specifically, this report outlines key concepts of the deduction, identifies payroll and reporting considerations, and highlights issues unique to public-sector compensation structures. This document is intended to support compliance, promote consistency, and reduce risk while recognizing that federal agencies may issue additional regulations or interpretive guidance for this provision in the future.

The One Big Beautiful Bill Act of 2025 (also known as the Working Families Tax Cut Act) includes the new federal income tax deduction commonly referred to as the "No Tax on Overtime" provision. This provision allows eligible employees to deduct qualifying overtime compensation from their federal taxable income, subject to statutory limits and conditions. While the deduction is claimed by employees on their individual income tax returns, its implementation has important implications for local government employers, particularly those with workforces that routinely earn overtime, such as public safety, public works,

utilities, and emergency services.

Employers play a critical role in accurately calculating, classifying, and reporting overtime compensation through payroll systems and year-end tax reporting. Inconsistent practices or misunderstandings regarding what constitutes qualifying overtime could lead to employee confusion, reporting errors, or increased administrative burdens.

For the 2025 tax year, local government employers were not responsible for determining employee eligibility for the deduction nor for providing separate breakdowns of eligible overtime compensation to employees. Though not required for the 2025 tax year, the Internal Revenue Service (IRS) encourages employers to provide employees with separate accountings of qualified overtime compensation if possible. Beginning in 2026, employers are required to separately report qualified overtime compensation on Form W-2 and other IRS tax statements. However, at the time of this publication, the IRS has not released detailed employer reporting requirements for the deduction in tax years 2026 – 2028.

This report does not constitute legal or tax advice. Local government employers should consult their legal counsel, payroll providers, and official guidance from the IRS and U.S. Department of the Treasury when implementing or responding to questions related to the Act.

MTAS Recommendations

MTAS recommends that municipalities proactively approach and educate their employees about the Act and its implications and requirements.

It is recommended that municipalities:

- Continue to monitor IRS guidance for updates regarding the implementation of the Act and tax form changes. The information provided reflects a "snapshot" of that available at the time of this publication.

- Communicate with payroll vendors and/or adjust payroll systems to ensure that qualified overtime compensation is accurately entered and recorded.

- Conduct an audit of employee classifications as they relate to FLSA exempt or non-exempt status to ensure FLSA compliance and to avoid misclassifications that lead to employees missing out on this tax-advantaged income.

- Educate employees on the "No Tax on Overtime" provisions regarding the specific type of overtime that qualifies for the deduction and that there is no impact to tax withholding.

- Though not required for the 2025 tax year, if possible, provide employees with estimates of qualified overtime compensation received in 2025.

What is the "No Tax on Overtime" deduction provision?

Section 70202 of House Resolution 1 amended IRC §225 to allow certain taxpayers to deduct qualified overtime compensation from their taxable income. In practical terms, this means that certain overtime pay may not be subject to federal income tax when employees file their individual tax returns, subject to limits and conditions established in the law and subsequent federal guidance.

The provision does not change how overtime is earned, approved, or paid by employers, nor does it eliminate payroll withholding requirements at the time wages are paid. Instead, it creates an above the line tax deduction that employees may claim when filing their annual federal income tax return. As previously noted, the deduction applies only to overtime compensation as defined under the FLSA and does not automatically extend to all premium pay, incentives, or specialty pay.

For local government employers, the provision primarily affects payroll reporting and employee communication rather than compensation practices. Employers are responsible for accurately calculating and reporting overtime wages, while employees are responsible for determining their eligibility for and claiming the deduction. Employers should rely on official federal guidance for detailed definitions, thresholds, and implementation requirements as they continue to be made available.

Effective Date of the Act and Timeline

The Act was initially signed into law on July 4, 2025, to be effective retroactively for the 2025 tax year and extending through the 2028 tax year. On November 5, 2025, the IRS announced transition relief for employers for the 2025 tax year (IRS Notice 2025-62). On November 21, 2025, the IRS published guidance (IRS Notice 2025-69) for the deduction for the 2025 tax year and has committed to providing updated W-2 forms for employers for use applicable to the 2026 – 2028 tax years to report qualified overtime compensation.

Key Definitions

As used in the Act and as referred to by reference:

- Overtime Premium Rate is the amount of overtime pay that exceeds regular pay (i.e. the half portion of time-and-a-half).
- Qualified Overtime Compensation is overtime compensation paid to an individual required under section 7 of the FLSA that is in excess of the regular rate at which such individual is employed.
- Regular Rate (FLSA) shall be deemed to include all remuneration for employment paid to, or on behalf of, the employee subject to the eight exclusions outlined in section 207(e).

Deductible Overtime Qualifications

Taxpayers can only deduct, and employers must separately report (beginning in the 2026 tax year), overtime compensation that exceeds regular pay based on section 207 of the FLSA.

- Employees must have overtime earnings which were paid at a higher rate (i.e., overtime premium rate) than the employee's regular wages.
- Only the overtime premium pay that is required by federal law under section 7 of the FLSA qualifies for the deduction.
- Individual taxpayers can deduct up to $12,500 ($25,000 for joint filers) in qualified overtime compensation from federally taxable income.
    - Note – the tax deduction begins to phase out for individuals whose modified adjusted gross income exceeds $150,000 ($300,000 for joint filers).
- For local government employees who receive at least 1.5x the regular rate of pay for hours worked more than 40 per week, only the "half" portion of the time-and-a-half pay is eligible to be deducted.
- For public safety employees (police and firefighters), who receive at least 1.5x the regular rate of pay for hours worked more than those allowed under the FLSA §207(k) based on work periods of between 7 to 28 days, only the "half" portion of the time-and-a-half pay is eligible to be deducted.
    - Overtime is due when the number of hours worked bearing the same relationship to 212 (fire) or 171 (police) as the number of days in the work period bears to 28 days is exceeded.
- Overtime premium pay for hours worked based on state law or local policy above that which is required in accordance with the FLSA is NOT eligible for deduction.

Employee Eligibility

Regarding local government employees, taxpayers must meet the following requirements to deduct *qualified overtime compensation*:

- For deduction eligibility, employees must have a valid Social Security number.
- Employees must be FLSA covered and non-exempt.
- Employees must have overtime earnings which were paid at a higher rate (i.e., overtime premium rate) than the employee's regular wages.

FAQs

If an employee meets all eligibility requirements, will the employee automatically receive the deduction?

No, at least not for the 2025 tax year. The tax filer is responsible for claiming the deduction and maintaining appropriate records/documentation to support the deduction claim. For the 2026 – 2028 tax years, H.R. 1 requires that employers report qualified overtime compensation on appropriate tax forms like the employees' W-2 forms and furnish employees with statements separately accounting for qualified overtime compensation. Additional rules and guidelines for reporting and filing requirements relative to the deduction for tax years 2026 – 2028 are expected and may be different.

What if an employee receives the overtime premium rate of pay based on local policies that are more generous than provided for in the FLSA?

Only the overtime premium rate portion of overtime compensation earned for working more than the FLSA maximum allowable hours (thresholds) is eligible to be deducted. This is usually 40 hours, but police and firefighters paid on a 207(k) work period basis have alternate allowable hours based on the length of the work period.

Therefore, any overtime premium earned for working hours below the FLSA thresholds is not eligible to be deducted.

- Example 1. Employee A is a FLSA-covered non-exempt public works employee who earns overtime at the time-and-a-half rate of $30 ($20 regular rate + $10 overtime premium) for hours worked over 37.5 hours each week. Employee A works 45 hours in a week.

  The overtime premium rate for hours 38, 39, and up to 40 is not qualified overtime compensation eligible to be deducted. The overtime premium portion of work hours 40 – 45 is qualified overtime compensation. Employee A may deduct $50 ($10 overtime premium x 5 hours) of the total overtime compensation in this scenario.

- Example 2. Employee B is a FLSA-covered firefighter who earns overtime at the time-and-a-half rate of $27 ($18 regular rate + $9 overtime premium) on hours worked over 212 in a 28-day "work period" basis. Employee B works 240 hours in a work period.

  Only the overtime premium for hours over 212 - 240 is qualified overtime compensation in accordance with the FLSA §207(k). Employee B may deduct $252 ($9 overtime premium x 28 hours) of the total overtime compensation in this scenario.

- Example 3. Employee C is a FLSA-covered police officer who earns overtime at the time-and-a-half rate of $45 ($30 regular rate + $15 overtime premium) on hours worked over 86 in a 14-day "work period" basis. Employee C worked 72 hours on regular shifts, 4 hours each on two separate *call-outs* from off duty, and was on annual leave for 8 hours during the work period. The municipality has a policy that all *call-out* hours are paid at the time-and-a-half rate.

  Only the overtime premium for hours worked exceeding 86 hours is qualified as overtime compensation in accordance with the FLSA §207(k). In this scenario, Employee C earned 72 hours regular pay for working, 8 hours annual leave pay for approved leave off duty, and 8 hours of overtime for the two separate 4-hour call outs. Employee C may not deduct any of the overtime paid in this scenario because overtime earned was solely a result of the municipal policy which exceeds what is required by the FLSA.

My agency considers paid leave as time worked for overtime calculations. How does this apply to the "No Tax for Overtime" deduction?

It does not. The FLSA does not require employers to give their employees time off for holidays, vacations, or sick leave. Considering them as time worked for overtime calculations is above and beyond what is required by the FLSA. For the purposes of the "No Tax on Overtime" provisions, these types of leave should not be considered as hours worked towards the FLSA overtime thresholds.

How is FLSA compensatory time contemplated under the "No Tax for Overtime" deduction?

Employees receiving compensatory time in the place of overtime amounts due under section 7 of the FLSA may take the overtime premium portion (half portion of time-and-a-half) amount into account for purposes of the deduction only in the year the compensatory time is paid. When paid out, compensatory time must be paid out at the regular rate that the employee earns on date of payment. Compensatory time that is used by an employee for time off at a date after it was earned is not eligible.

- Example 1 (adapted from IRS Notice 2025-69). Employee D works for a local government agency that gives compensatory time at a rate of one and one-half hours for each overtime hour worked under FLSA 207(o). In 2025, Employee D was paid wages of $4,500 with respect to compensatory time off taken in accordance with section 207(o). For purposes of determining the amount of qualified overtime compensation received in tax year 2025, Employee D may include $1,500, or one-third, of these wages for purposes of determining qualified overtime compensation under the deduction.

What if an employee has specific questions about how the deduction may impact their federal income tax liability?

While employers should be prepared to field questions from employees about the Act and associated overtime payment reporting, employees should be referred back to their own tax professional for tax advice and questions about claiming the deduction. The employer is obligated only to report qualified overtime compensation under FLSA for each tax year to employees.

Does "No Tax on Overtime" affect employer's obligations regarding federal income tax withholding?

No, an employer is required to complete all income tax withholdings throughout the tax year in the ordinary manner including that for premium overtime which may be deductible by the income tax filer. It is the employer's responsibility for tax year 2026 and beyond to accurately track and report premium overtime pay on appropriate IRS forms; however, it is the employee's responsibility to properly deduct premium overtime from his/her federal income tax return.

The Act was signed into law on July 4, 2025, so how does it affect qualified overtime compensation earned and paid between January 1, 2025, and July 4, 2025?

The deduction was made retroactive to include the 2025 tax year in its entirety. While signed into law in July, the deduction is retroactive to January 1, 2025.

For 2025, can an employer report an employee's qualified premium overtime pay?

For the 2025 tax year, employers are exempt from reporting requirements for qualified premium overtime pay; however, employers have the option to report the amount of qualified overtime compensation to employees using methods specified by the IRS.

Does "No Tax on Overtime" apply to contractors working for local government employers?

Unfortunately, this question is difficult to answer as no IRS official guidance has been provided as of the date of this publication. Early guidance indicates that contractors are not eligible because they are not W-2 employees.

Conclusion

The "No Tax on Overtime" deduction in the One Big Beautiful Bill Act is an important change that will affect many local governments and employees who earn overtime pay. Although employees claim the deduction on their personal tax returns, employers still have a role in making sure overtime hours and pay are tracked and reported correctly and are required to do so beginning in the 2026 tax year.

Department heads should focus on ensuring that overtime is approved, recorded, and coded accurately in payroll systems. Clear and consistent practices will help avoid mistakes, reduce employee questions, and limit the risk of reporting problems. Department heads and human resources, finance, and payroll staff should work closely to make sure everyone is using the same definitions and procedures.

It is also important to understand that federal guidance may change as the law is implemented. Staying informed and following established procedures will help employers to respond appropriately as additional guidance becomes available.

The new tax benefit potentially increases the financial advantage of being a non-exempt, overtime-eligible employee. Therefore, employers should perform an audit of their exempt classifications to avoid misclassifications that could lead to employees missing out on this tax-advantaged income. By paying attention to accurate overtime practices and clear communication, local government employers can support their employees while ensuring the organization remains compliant with federal requirements.

Please contact your MTAS consultant(s) for questions or assistance. Here is a link to the MTAS staff directory: https://www.mtas.tennessee.edu/mtas-staff.

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