Overtime Pay Tax Deduction

Changes are now in effect from new federal law

by: Greg Goldberg, BTA General Counsel

On July 4, 2025, President Donald Trump signed the One Big Beautiful Bill Act into law. Spanning approximately 870 pages, the new federal law (Public Law 119-21) includes a broad range of domestic policy initiatives and economic priorities. To name just a few examples, the law implements significant changes to health care, immigration, national defense, energy, taxes and debt-ceiling policies. Although the full impact of the law may not be known for some time, BTA members should be aware of certain provisions with immediate consequences. This month, Legal Perspective looks at the law's effect on overtime pay.

How the Overtime Pay Tax Deduction Works

The law introduces several tax reforms tailored to non-exempt workers who rely most heavily on overtime pay and tips to supplement their hourly wages. Among those reforms, backers of the law trumpet a "no tax on overtime" provision. A close examination of the overtime tax deduction reveals this claim to be exaggerated. While it is technically true that most hourly workers can expect to pay less in overall taxes on a portion of their overtime wages, in practice, the law does not come close to eliminating taxes on overtime. The new federal tax deduction only applies to the premium portion of overtime. In other words, where overtime pay is typically paid out at a rate of 1.5 times (or "time and a half"), the tax exemption only applies to the extra half-hourly rate.

To illustrate how the overtime tax deduction under the law works, let's consider a hypothetical scenario. Suppose, for example, an hourly worker earning $30 per hour works 41 hours in one week in a state where overtime kicks in after 40 hours. That worker should be paid 40 hours at the regular rate of $30 per hour ($1,200), plus one hour at the time-and-a-half rate of $45 per hour. If the law eliminated all taxes on overtime, the entire amount of pay for the 41st hour ($45) would be exempt from federal income tax.

But that is not how the law works. Overtime pay is not exempt from federal income tax under the law; rather, our hypothetical worker is only permitted to take a tax deduction for the premium portion of the overtime pay, meaning the worker can only deduct $15 from his (or her) adjusted gross income on his federal tax return. This tax deduction applies to overtime pay earned beginning Jan. 1, 2025, and remains in effect through Dec. 31, 2028, unless Congress chooses to extend it. The overtime deduction is capped for individual filers at $12,500 and for joint filers at $25,000. The deduction phases out for individual filers earning more than $150,000 per year and joint filers earning more than $300,000 per year.

Impact on BTA Members

For BTA members with hourly employees, the new overtime tax deduction may require some operational changes over the next several years:

■ **Timekeeping:** First, it is important to ensure accurate reporting and timekeeping for overtime. Hourly employees will only see a boost in their take-home pay if they can take full advantage of the tax deduction. This starts with accurate payroll records.

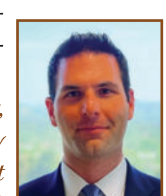
■ **Withholding:** For the moment, federal withholding remains the same for 2025. The IRS has confirmed that no changes will be made to withholding tables or W-2 forms for the current year.

■ **Increased Record-Keeping & Reporting:** Employers will now be required to separately track and report overtime premiums on employees' W-2 forms for the 2025 tax year and onward. While the IRS allows employers to utilize reasonable estimation methods for the current year, clarity and accuracy will be essential going forward.

■ **No Change to Social Security or Medicare Withholding:** The overtime tax deduction affects only federal income tax. Overtime pay remains fully subject to FICA, as well as any state or local taxes.

Next Steps

It is always a best practice to communicate changes in take-home pay to employees, including how the overtime tax deduction works and what the limitations are. Updates to federal withholding rules are expected to be implemented for 2026, so continue to monitor this space for additional guidance from the IRS. The new law offers a modest way to enhance employee compensation without affecting payroll tax structure — at least for now. ■



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