

How Will Federal Bills Eliminating Tax on Tips and Overtime Impact Employers?

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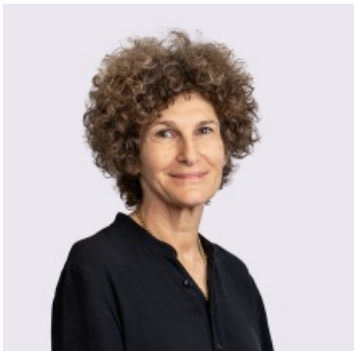


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Takeaways

- The House and Senate bills differ in key ways, including that while the House bill would provide a deduction on tips and overtime earnings, the Senate bill provides a deduction for tips only.
- It remains to be seen which measures will pass in Congress. President Trump is expected to sign a bill that provides some sort of tax relief on tips or overtime pay.
- Employers could consider restructuring compensation policies.

Article

Tax breaks on overtime pay and tipped earnings passed the House on May 22, 2025, as part of the “One Big Beautiful Bill Act” (H.R. 1). The tax deductions provided under the sprawling reconciliation bill would be temporary, however, making these earnings deductible only for tax years 2025 through 2028.

H.R. 1 is part of the broader reconciliation package being hammered out in Congress. The legislation still needs to be approved by the Senate, which recently passed its own standalone bill providing a permanent tax deduction on tipped earnings. The Senate bill does not include tax relief on overtime pay (although several other Senate bills to provide a tax break on overtime are pending).

Both the House and Senate bills restrict the tax deduction to workers earning less than \$160,000 per year. That is the current IRS threshold for defining “highly compensated employees” under IRC section 414(q)(1)). This is a different standard than the Department of Labor’s criteria for defining the “highly compensated employee” exemption under the Fair Labor Standards Act (FLSA). Also, under both bills employees’ tips and overtime pay would still be reportable and remain subject to payroll taxes.

There are key differences between the House and Senate bills, however. It remains to be seen which (if either) will make its way to the president’s desk. The reconciliation bill must now go before the Senate, where several Senate Republicans have indicated their intention to push for significant changes before passing the bill. Lawmakers aim to bring the bill to a vote by August. President Donald Trump has expressed his support for eliminating taxes on tips and overtime. He is expected to sign such a measure if passed by Congress.

“One, Big, Beautiful Bill”

The reconciliation package creates a temporary deduction from gross income for premium pay for overtime hours worked. The deduction applies only to compensation paid in excess of an employee’s regular rate of pay, as required under Section 7 of the FLSA. There is no cap on the amount of overtime earnings that an employee may

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Related Services

Hospitality
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deduct.

H.R. 1 also creates a temporary deduction from gross income for tips earned by workers — both statutory employees and self-employed independent contractors — in “traditionally and customarily tipped industries,” typically the hospitality industry (restaurants and hotels) but there are other businesses where tips are common (such as barber shops and hair salons). The legislation extends an employer tax credit for Social Security taxes paid on tips, currently applicable only to food or beverage service employees, to include tips customarily earned by employees providing beauty services such as hair care, nail care, and spa treatments.

To deter improper reclassification of regular pay as tips to qualify for the deduction, the treasury secretary would be directed to provide, within 90 days of enactment, a list of industries where tips have customarily been earned on or prior to Dec. 31, 2024.

A “qualified tip” is one paid voluntarily by the customer or client, not subject to negotiation. Earnings from mandatory service charges assessed automatically to customers would not be deductible.

Businesses would need to separately report tips and overtime earnings on employees’ W-2 forms and, for non-employees, report the portion of payments that are designated as tips, a requirement that also extends to “third party settlement organizations” such as gig economy companies.

Senate No Tax on Tips Bill

The freestanding Senate bill would provide tipped employees with a permanent tax deduction of up to \$25,000 per year for qualified tips. (H.R. 1 does not cap the amount of tipped income that workers can deduct.)

Qualified tips would include tips received by employees in connection with delivering or serving food or beverages for consumption (if tipping is customary), and tips earned from providing beauty services (if tipping is customary). Like H.R. 1, the Senate measure extends the employer tax credit to beauty service establishments.

The Senate measure also requires the treasury secretary to provide a list of occupations entitled to the deduction, namely, industries that “traditionally and customarily received tips on or before December 31, 2023.”

The Senate bill provides a tax deduction for tipped employees only; it does not extend the deduction to independent contractors.

The Senate-approved No Tax on Tips Act (S. 129) passed by unanimous consent on May 20, 2025, and now heads to the House for consideration.

State Laws

The pending federal bills would allow deductions from federal income taxes only. Several state legislatures in both blue and red states have introduced bills to create a deduction from state and local taxes for tips or overtime pay. These provisions vary. Some measures, for example, would eliminate tax on cash tips but retain the tax on credit card tips. Some impose affirmative reporting requirements on employers.

Alabama currently exempts hourly workers’ overtime pay from state income tax and withholding. The Alabama legislation was a temporary inflation relief measure passed

for the tax year beginning Jan. 1, 2024. It was extended last year to exempt overtime pay earned through June 30, 2025.

Impact on Employers

With a tax deduction on overtime pay, employees would likely be more willing to work overtime or take on extra shifts. Ironically, Congress enacted the FLSA's overtime provisions in 1938 to prevent overwork and to spread employment to more workers and reduce unemployment. To accomplish this, the FLSA discouraged employers from requiring employees to work overtime by making it more costly. Times have changed, and the ability to earn overtime wages not subject to tax may assist with reducing chronic staffing shortages in healthcare and other industries. This could result in higher overtime costs, particularly for public employers whose workers may be less willing to take compensatory time in lieu of overtime, as the FLSA allows.

Employers might restructure compensation to provide employees more take-home pay without incurring higher payroll costs by reducing pay for non-overtime hours and permitting more overtime work that is tax-free — a win for employers and employees. No tax on overtime could also result in requests from employees to be reclassified as non-exempt because more of their earnings will be tax-free. An exempt employee earning \$75,000, for example, where the full wages are subject to tax, might prefer to be a non-exempt employee and earn \$50,000 in regular wages and \$25,000 in overtime, not subject to income tax. Employers may be hesitant to undertake drastic changes to their pay practices, however, if the tax benefits are short-lived.

As for no-tax-on-tips, the hospitality industry will feel the biggest impact if the measure is passed. Tipped workers will benefit by having most of their earnings in tips. As such, the deduction would deflate the ongoing efforts of worker organizations that have been advocating at the state and local level to eliminate use of the tip credit and efforts by some employers to eliminate all tipping at restaurants and use service charges or higher prices instead.

The tax deduction also could be a boon for recruitment, raising the appeal of tipped work and easing the strain of ongoing labor shortages in the industry. In states that permit back-of-the-house workers (such as cooks) to participate in a tip pool (permitted under federal law if no tip credit is taken), the tax deduction may also benefit kitchen workers. But, in other states, it may widen the asserted unfairness between servers and kitchen staff regarding compensation. Hospitality employers may need to consider a review of their compensation practices as the favorable tax treatment for tips will increase the divide between the earnings of tipped and non-tipped workers.

Please contact your Jackson Lewis attorney if you have questions about how deductions for tipped earnings and overtime pay, if enacted, would impact your organization.

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