

# OBBBA's Tips + Overtime Tax Break: Reclassification Considerations, Reporting Requirements, Industry Impact + More

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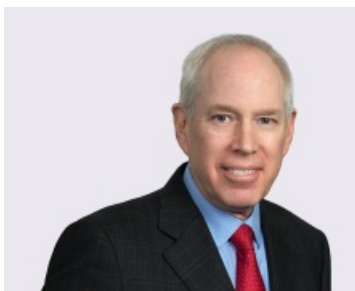
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## Takeaways

- Employers will need to update payroll and reporting systems to meet OBBBA's new requirements for reporting employees' tips and overtime earnings.
- The temporary tax deductions for tips and overtime provide opportunities to restructure compensation policies to maximize employees' nontaxed income.
- Until IRS regulations and guidance flesh out further details of what the new law requires and allows, deductions on tips and overtime earnings are uncharted territory — employers should consult with counsel before undertaking drastic changes to established pay practices.

## Related link

- [Federal OBBBA Round-Up: What Employers Need to Know Now](#)

## Article

The 2025 federal budget law, the "One Big Beautiful Bill Act" (OBBBA), contains numerous provisions that directly impact employers. (See [Federal OBBBA Round-Up: What Employers Need to Know Now](#).) Among these provisions are temporary tax deductions on tipped earnings and overtime pay. Both deductions are set to expire after the 2028 tax year. The law imposes additional requirements on reporting of workers' tipped and overtime earnings. The new deductions may present opportunities to restructure compensation policies to maximize employees' nontaxed income.

Here, we recap the key features of the tax deductions for tips and overtime pay, what they mean for employers, and the questions that remain as we await regulatory guidance.

## Tax Deduction on Overtime Premium

The OBBBA creates a limited deduction for overtime pay premiums required by the Fair Labor Standards Act (FLSA). Premium pay is the amount paid in excess of an employee's regular rate of pay. For example, if an employee's regular rate is \$15 per hour, the employee's overtime rate (time and one-half) is \$22.50 per hour. Only the \$7.50 overtime premium for that hour may be deducted.

The annual deduction is capped at \$12,500 (or \$25,000, in the case of a married employee filing a joint return). For married individuals, the deduction is available only if the employee files a joint return. The deduction decreases for employees who earn more than \$150,000: the allowable deduction is reduced by \$100 for each \$1,000 (10%)



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by which an employee's gross income exceeds \$150,000 (or \$300,000, in the case of a joint return). For example, if the employee's income is \$200,000, then the deduction is reduced by essentially 10% of \$50,000, or \$5,000, leaving the employee with a \$7,500 deduction from overtime earnings. A single individual earning \$275,000 or more would not be eligible for any deduction.

Importantly, not all "overtime" pay is eligible for the deduction. Only overtime pay *required* by the FLSA is deductible. Employees may not deduct additional overtime earned under state law requirements (*e.g.*, daily overtime). Nor can they deduct extra overtime paid pursuant to a more generous collective bargaining agreement, or employer compensation policy, such as double-time for working a holiday (where the hours do not exceed 40 hours in a week).

Additionally, because the overtime deduction is limited to overtime required by the FLSA, overtime paid to exempt employees (*e.g.*, employers will sometimes pay additional straight-time compensation or time-and-one half to otherwise exempt employees when they work more than 40 hours) is not subject to the deduction because the overtime pay is voluntarily provided and not *required* by the FLSA.

The law provides the deduction for overtime does not apply to qualified tips. Although the meaning of this provision is unclear, it likely indicates that a tipped employee who is paid the tip credit rate (below the minimum wage) and works overtime can take a deduction only for the premium in excess of the minimum wage, excluding the tip credit. For example, if the state minimum wage is \$15.00 per hour, and the cash wage for a tipped employee is \$10.00 per hour, the "tip credit" is \$5.00 per hour. The overtime rate for a tipped employee in this example is \$22.50 (1.5 x \$15.00), but, given the tip credit, the employee receives \$17.50 (\$22.50 - \$5.00) for each hour of overtime. The deduction for overtime premiums is likely limited to \$2.50, the premium directly paid by the employer over the minimum wage, not the \$7.50 per hour overtime premium. The tipped employee may be eligible, however, for a separate deduction for tips received, as discussed below. This provision likely prevents double-dipping.

## Reclassify Exempt Employees?

The deduction on overtime pay is a win for employees. Indeed, it may make overtime more appealing to workers. In addition to the overtime pay, employees will now get a boost on top of the additional pay — a tax deduction. Ironically, when Congress enacted the FLSA's overtime provisions, it intentionally made overtime more costly to discourage employers from having employees work overtime to prevent overwork and spread employment. The new law creates arguably the opposite incentive for employees — it *encourages* employees to seek overtime by making it even more lucrative.

To maximize the benefit for employees, employers might consider reclassifying exempt employees to nonexempt. For example: An exempt employee who earns \$75,000 per year and routinely works more than 40 hours in a workweek could be reclassified as nonexempt with an annual salary of \$50,000, working the same number of hours per week. The employee takes home \$50,000 in regular wages and \$25,000 in overtime premiums. In this scenario, \$12,500 of the employee's overtime premiums would be deductible (or \$25,000 if the employee is filing a joint return). Restructuring their compensation in this manner lets the employee reap the benefit of more pay at no cost

to the employer.

Reclassifying employees as nonexempt also means more flexibility for employers to control payroll costs by reducing employees' work hours when not needed.

Of course, not everything is so rosy. There are drawbacks to adopting this strategy:

- Employers will have the added burden of tracking work hours of previously exempt employees. Newly nonexempt employees also will need to follow timekeeping requirements: time sheets, timeclocks, rigid meal breaks, and docked pay for hours not worked.
- Formerly exempt employees may view the reclassification as a demotion. They also may be giving up certain perks of exempt status and certain employee benefits, as well as their own scheduling flexibility.
- Predicting overtime needs can be a challenge. Unanticipated overtime may prove to be more costly for the employer; conversely, newly nonexempt employees who do not work the overtime hours they expected may see a loss of income.
- Employers also must consider the limitations of the tax deduction in the cost-benefit analysis: Overtime earnings are still subject to Social Security and Medicare withholdings, as well as state and local taxes. That reduces the value of the federal deduction, especially for lower-earning workers. For high earners, the available tax deduction is reduced starting at \$150,000, so reclassification provides less benefit for these employees. For lower-wage earners, the tax benefit may permit an employer to provide employees with a pay increase simply by restructuring the way they are paid, without increasing the amount.

## Deductions on Tipped Earnings

The OBBBA creates a separate deduction for tipped workers, allowing them to deduct up to \$25,000 of qualified tips earned. Like the overtime deduction, the allowable deduction for tipped earnings is reduced by \$100 for each \$1,000 by which the tipped worker's gross income exceeds \$150,000 (or \$300,000, in the case of a joint return). As with the overtime deduction, workers must continue to pay Social Security and Medicare taxes on tip earnings, as well as state and local taxes.

To be a "qualified" tip, the tip must be paid voluntarily by the customer or client, not subject to negotiation. Therefore, earnings from mandatory service charges assessed automatically to customers are not deductible. Tips received under tip-sharing arrangements count as qualified tips.

The deduction is available only for tips earned in "traditionally and customarily tipped industries." This most typically means the hospitality industry (such as restaurants and hotels), but there are other businesses where tips are common (such as barber shops and hair salons). The new law aims to minimize the prospect that employers and employees may abuse the tip deduction by reclassifying as tipped income the compensation earned by workers who do not typically work for tips. To that end, the treasury secretary will publish a list of occupations that have customarily and regularly received tips on or prior to Dec. 31, 2024.

The tip deduction also applies to independent contractors and self-employed individuals who earn tips in the course of a trade or business — but only to the extent the income from that trade or business (including tips) exceeds the full sum of allowable deductions (not counting the tip deduction) allocable to that trade or business. This provision may be most applicable to gig workers who are classified as independent contractors but receive substantial tips.

In addition, the OBBBA extends an existing 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.

### Tip Deduction: Industry Impact

Tipped workers stand to benefit by having most of their earnings in tips rather than straight wages. Consequently, the tax deduction on tips may deflate a recent trend at the state and local levels to eliminate use of the tip credit employers may take against minimum wage requirements. Passage of OBBBA may push these states and localities to reconsider recently enacted laws eliminating the tip credit. (Already, Washington, D.C. paused the next phase of the city’s gradual rollback of the tip credit.)

Further, the tip deduction could slow a growing trend in restaurants to replace traditional tipping with a service charge model.

Hospitality employers also have adopted commission-based compensation, typically for banquet or catering staff, which qualifies the servers as exempt from overtime under FLSA Section 7(i)’s “retail or service establishment” exception. With the deduction on tipped earnings, however, employers may face pressure to revert to the traditional tipping model or suffer a competitive disadvantage in recruiting service staff if they choose not to do so.

The deduction on qualified cash tips may present other challenges. Some states allow back-of-the-house workers (such as cooks) to participate in a tip pool. This is permitted under the FLSA if the employer does not take a tip credit. In those states, the tax deduction may also benefit kitchen workers. In states that prohibit the practice, however, the deduction may widen the asserted unfairness between service staff and kitchen staff regarding compensation. The servers will be eligible to receive up to a \$25,000 tax deduction, but the cooks, who may earn less in regular wages, will not be eligible. This could increase the divide between the earnings of tipped and non-tipped workers.

### Reporting, Withholding Requirements

The OBBBA’s tip and overtime pay deductions impose additional reporting obligations on employers. Employers will be required to report on Form W-2 the portion of an employee’s pay that is qualified overtime compensation in excess of the employee’s regular hourly rate. For the tip deduction, employers must separately report the specific portion of a tipped employee’s pay that is qualified tips and identify the employee’s qualifying tip-earning occupation.

Likewise, businesses that retain independent contractors will need to report the amount of qualified tips earned on Form 1099. Reporting requirements also extend to “third-party settlement organizations” such as gig economy companies. These companies

must report the portion of payments made that were “reasonably designated by payors as cash tips,” along with the occupation of the payee receiving those tips. (The OBBBA also states that businesses must report qualified *overtime* pay earned by independent contractors. This provision could be a result of hasty drafting, however. The new law makes clear that the overtime deduction is available only to overtime premium pay “required under section 7 of the FLSA,” and independent contractors are not FLSA-covered workers entitled to overtime compensation.)

Employers will continue to withhold income taxes on qualified tips and overtime pay, but the IRS will modify withholding amounts to account for the new deductions for tax years beginning after Dec. 31, 2025. For the current tax year, a transition rule permits employers to approximate a separate accounting of amounts designated as cash tips or qualified overtime pay by any reasonable method specified by the IRS.

### Awaiting Further Guidance

The IRS will need to flesh out a number of unknowns and revise its tax withholding procedures and forms to incorporate the tip and overtime deductions.

- For the current tax year, businesses may “approximate” the amount of qualified tips and overtime pay on employees’ W-2 forms. Employers should be on the lookout for IRS guidance specifying the “reasonable method” that employers may use in estimating these earnings.
- The treasury secretary has an Oct. 2, 2025, deadline to publish the list of occupations eligible to take the tip deduction. Tipping culture has expanded in recent years, with a growing array of businesses urging customers to leave gratuities for their workers. It remains to be seen whether the IRS will interpret “traditionally and customarily tipped” to encompass part of this “tip creep.”
- The OBBBA directs the treasury secretary to issue “necessary and appropriate” rules and guidance to deter abuse of the overtime deduction. What might such a regulation entail? The IRS could potentially adopt a rule to discourage widespread reclassification of exempt employees. The new law provides no timeline for the IRS to promulgate the required rule and guidance.

### Employer Takeaways

Deductions on tips and overtime earnings are uncharted territory. Some open questions will be answered by upcoming guidance. There are steps employers can begin to take now:

- Adjust payroll systems to accurately capture the required compensation information (tips and overtime premiums); or
- Ensure your payroll vendor incorporates the necessary changes.

Given the inherent risks, employers should consult with counsel before undertaking drastic changes to established pay practices. As a practical matter, as the tax breaks are set to expire in three years, the benefits of revamping compensation policies may be short-lived. It is possible Congress may extend the deductions, but it is not assured.

Please contact your Jackson Lewis attorney if you have questions about the OBBBA and its impact on your business or need assistance navigating the requirements of the

new law.

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