KP LAW
THE LEADER IN PUBLIC SECTOR LAW

eUpdate

Employer Reporting Requirements under the "No Tax on Overtime" Provision of the One Big Beautiful Bill Act Begin for TY 2025

(Prepared for 2026 MMA Connect 351)

"No Tax on Overtime", a significant provision of the One Big Beautiful Bill Act ("Act"), allows employees to deduct from their federal taxable income a portion of their "qualified overtime compensation" ("QOC"), as that term is defined under § 7 of the Fair Labor Standards Act ("FLSA"). The provision also requires employers to report QOC earned for the taxable year ("TY") on employee tax documents. While the IRS has clarified that for TY25 employers will not be penalized for failing to report or for inaccurately reporting QOC on employee tax documents, the Act's "No Tax on Overtime" changes have significant implications for municipalities and their employees for TY25 through TY28.

Overtime Definition/Hours & Reporting

Recent IRS guidance, effective for TY25 through TY28, provides that employees who earn QOC may deduct a portion of their overtime compensation from their taxable income. This deduction is available only to employees with a modified adjusted gross income ("MAGI") of $150,000 or less for single filers, or $300,000 or less if filing jointly. The maximum allowable deduction is $12,500 for single filers and $25,000 for joint filers.

Critical for municipalities, and a departure from most current municipal overtime tracking practices, the Act adopts the definition of QOC from § 7 of the FLSA. Under § 7, QOC is the "half" in the FLSA's "time-and-a-half" rate of pay rule for hours worked exceeding 40 hours a week. When calculating QOC, the FLSA considers only the actual "hours worked" by an employee. The FLSA does not count time not worked – such as vacation days, sick days, or federal or other holidays – in the 40-hour workweek calculation. It is not uncommon for municipalities, typically pursuant to a collective bargaining agreement or individual contracts, to provide greater overtime benefits than the FLSA requires, such as affording overtime when an employee works over 8 hours in a given day, or paying overtime for unscheduled work regardless of how much vacation or other paid time off was utilized during that same work week. However, the hours gained through these greater overtime benefits are not considered QOC for purposes of the FLSA unless the employee has also met the FLSA's threshold of at least 40 hours of actual work in that week. Consider, for example, a situation where a collective bargaining agreement counts vacation hours as "hours worked" for overtime purposes. If an employee works 33 hours and takes 8 hours of vacation in a week, that would result in a total of 41 hours in that week. Under that collective bargaining agreement, the employee would likely be eligible for at least 1 hour of overtime pay. However, in this same scenario, no portion of that employee's wages would be eligible for the Act's tax exemption on overtime and would not be reported as QOC on the employee's W-2. This is because per § 7 standards, the employee has only actually worked for 33 hours in that week.

The Act also contemplates the various overtime calculation and payment frameworks authorized under 29 U.S.C. § 207. For example, the FLSA permits alternative overtime rules for certain municipal employees, including: § 207(k), which modifies when overtime accrues for public-sector fire protection and law enforcement employees by allowing extended work periods; and, § 207(o), which allows public employers to satisfy overtime obligations through granting compensatory time off in lieu of immediate cash payment for overtime hours.

For purposes of the Act's "no tax on overtime" provision, QOC (if any) must be calculated in accordance with the overtime rules of the applicable subsection of § 207. Therefore, to ensure accurate reporting of QOC on employees' tax documents moving forward, municipalities should consider implementing a change to separately track overtime for internal purposes, such as, overtime compensation earned as defined in collective bargaining agreements or possibly individual employment contracts, and for federal tax purposes, such as wages earned for hours actually worked beyond 40 hours/week, or hours and other compensation earned under the applicable subsection of § 207.

Application to TY25 (Temporary Penalty Relief)

For TY25, the IRS and Treasury will provide "transitional relief" from penalties for employers that do not separately or accurately report the total amount of QOC an employee has earned in the year, so long as the employer otherwise files complete and accurate returns and statements. For now, this relief is limited to TY25 and reflects the IRS's recognition that many employers currently lack the tools and information necessary to comply with the new reporting requirements of the Act, particularly because W-2 and 1099 forms will not be updated for TY25 to capture these amounts.

While penalties for failing to separately report or accurately report QOC in TY 2025 will be waived, IRS guidance still encourages employers to provide employees with a separate accounting of QOC through supplemental statements, secure portals, or Box 14 on employees' W-2s. This separate accounting may facilitate the employee's ability to claim the deduction in TY25. Accordingly, we anticipate that municipal employers can expect to receive employee requests for QOC supporting documentation for TY25. Additional IRS guidance for individual taxpayers on how to claim the qualified overtime compensation deduction for TY25 is expected to be forthcoming, as is guidance on employer reporting requirements.

Summary

In sum, the Acts's "No Tax on Overtime" provision requires employers for TY25-TY28 to report all QOC, as defined by § 7 of the FLSA, earned by employees as a separate line item on employees' W-2s or other tax documents. For TY25, employers will not be penalized for failing to separately report QOC or inaccurately reporting QOC amounts. However, municipalities may still receive requests for QOC accounting for TY25, and, for TY26-TY28, and will need to develop and implement accounting mechanisms for hours worked and QOC earned for both internal and external purposes, as described above.

We will continue to monitor any developments on the implementation of the No Tax On Overtime provision. Municipalities with payroll vendors, financial advisors, and/or outside accounting firms may wish to seek out

additional guidance and information on these matters. Information may also be obtained from the IRS Newsroom.

If you have any questions concerning the changes to overtime compensation and reporting requirements under the Act or its application to specific work periods or compensation schemes under 29 U.S.C. § 207, please contact Attorney Darren Klein or any member of the firm's Labor and Employment Practice Group at 617.556.0007.