

Transition – A Presidential Change Update

July 2025

What the New Law on Overtime and Tips Taxes Means for Employers

Key Notes:

- A new federal law allows workers (employees and independent contractors) to deduct up to \$25,000 in tips (for those who regularly receive tips) and \$12,500 (\$25,000 if filing a joint return) in overtime pay from their federal adjusted gross income.
- Income tax withholding requirements are not immediately affected by the legislation and employers must continue withholding at the current rates during 2025 on all tips and overtime as they were before the legislation took effect.
- The new law may assist employers of highly compensated hourly workers, such as nurses, servers in high-end restaurants, and construction workers, with recruiting and retention.

The recently enacted One Big Beautiful Bill Act (Act), signed on July 4 by President Trump, contains incentives to alleviate the federal income tax burden on overtime earnings and tips for qualifying workers. Although the legislation more directly affects workers, employers with highly compensated, nonexempt workers should be aware of the potential implications for both compliance and staffing practices.

Critically, the Act does not immediately modify the requirement for employers to withhold federal income taxes from employee paychecks. Because the Act provides an income tax deduction, workers will see the benefit, if any, for 2025 when they file their income tax returns. Beginning in 2026, the IRS will modify the income tax withholding rules to take into account both the qualified tip deduction and the qualified overtime deduction. Despite the delayed tax relief, many employers anticipate that the chance to deduct significant portions of overtime and tip income may help

attract and retain personnel, especially in industries where overtime hours and substantial tips are common.

Generally speaking, under the Act workers who receive qualified tips may deduct up to \$25,000 of their tip income when they file their federal income tax return. The IRS is required to publish a list of occupations that qualify by October 2, 2025. Workers earning qualified overtime may also deduct as much as \$12,500 (or \$25,000 for joint filers) of such qualified overtime from their adjusted gross income. Lower-wage earners will likely benefit from the new measures, if at all, to a modest degree (they must have a federal tax liability to begin with); higher earners who already face larger federal income tax bills stand to realize the greatest savings, although the deductions start to phase out for individuals with a modified adjusted gross income of more than \$150,000 per year (\$300,000 for joint filers).

What This Means for Employers

Employers should continue to withhold federal income taxes on both tips and overtime pay in accordance with existing law through the end of 2025, as workers will reconcile any deductions when they file their annual income tax returns. Importantly, employers and those who use 1099 contractors should also be prepared to report the amount of qualified tips and/or qualified overtime paid to each worker and the worker's occupation (for tips only) as required on Form W-2 and Form 1099, beginning with tax year 2025, which will be due in January 2026. A transition rule allows employers to use a reasonable method specified by the IRS to approximate qualified tips and overtime paid during 2025. Beginning in 2026, employers will have to adjust their income tax withholding practices for qualified

tips and qualified overtime based on future procedures to be issued by the IRS.

In practice, the new rules may influence competitive recruiting, directing more applicants toward positions offering generous overtime or ample tipping opportunities. High-end restaurants, hotels, and other customer-facing establishments might see staffing challenges or shifts in worker preferences if they do not adjust compensation structures to account for the potential windfall. Sophisticated customers of these establishments may adjust their tipping habits to account for the anticipated tax deduction available to these workers. Similarly, manufacturing firms and construction companies reliant on overtime labor may find it easier to staff extended shifts and cargo runs as workers look to maximize earnings. Hospitals and other medical institutions may need to evaluate overtime scheduling to sustain sufficient staffing while allowing eligible workers to take advantage of the new deductions.

For employers paying low to moderate wages, these tax advantages might not radically alter tax outcomes for their workforces, since the standard deduction often already covers much of lower-income workers' wages, and any additional tax is frequently eliminated by child tax credits or other credits.

Looking Ahead

While the qualified overtime and qualified tips deductions bring opportunities for workers across multiple industries, these provisions are temporary and will sunset on December 31, 2028. As the political and economic landscape evolves, further amendments and clarifications may arise, potentially modifying the scope of these deductions or extending their sunset date.

We will continue to monitor additional legislative and regulatory developments that may affect employers that offer overtime pay and those with tipped workforces. Proactive review of staffing structures, payroll systems, and federal income tax withholding processes will help ensure ongoing compliance and provide a sound basis for advising workers who inquire about these new rules and their impact on take-home pay.

FOR MORE INFORMATION

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