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“No Tax on Overtime” and “No Tax on Tips”: Key Considerations for Employers

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Despite the simple and catchy sound-bites, the “no tax on tips” and “no tax on overtime” opportunities under the One Big Beautiful Bill Act (the “OBBBA”) have limits and require administration by both employers and employees. Most significantly, the tax savings are in the form of deductions, rather than exclusions, which means that tips and overtime are still subject to FICA and other employment taxes; the deductions have limits; and employees must claim the deductions on their individual tax returns. Also, the deductions are available only for tax years 2025 through 2028.

IRS Notice 2025-69 (available here) provides useful guidance for the 2025 tax year, but there are still administrative details to be worked out for 2026 and beyond. Below is an overview of key points for employers.

Section 224: No Tax on Tips

The OBBBA added Section 224 to the Internal Revenue Code (the “Code”), allowing individuals to deduct qualified tips received during the taxable years 2025 through 2028. The deduction is available only to individuals working in an occupation that “customarily and regularly received tips on or before December 31, 2024.” The deduction is capped at $25,000 per taxable year (the statute does not distinguish between single and joint filers) and begins to phase out for taxpayers with a modified adjusted gross income (“MAGI”) above $150,000 (or $300,000 for joint filers).

What Are “Qualified Tips”?

To be “qualified,” a tip must be voluntarily determined by the customer and not be required or negotiated. This means that automatic gratuities are excluded, though any voluntary amount paid above them may qualify for the deduction.

The rules are agnostic with respect to form of payment: a qualified tip may be paid in cash, charged (for example, credit cards and Venmo), and tips received through tip-sharing arrangements may qualify.

The IRS released a preliminary list of occupations that "customarily and regularly" receive tips. The list is divided into eight categories, each with subcategories (available here):

1. Beverage and Food Service
2. Entertainment and Events
3. Hospitality and Guest Services
4. Home Services
5. Personal Services
6. Personal Appearance and Wellness
7. Recreation and Instruction
8. Transportation and Delivery

Notably, an otherwise eligible employee might be denied the deduction if their employer operates a "specified service trade or business" ("SSTB"), as defined under Code Section 199A. SSTBs generally include businesses in fields such as health, law, accounting, performing arts, and athletics. The Code also differentiates employees of certain SSTBs based on whether they perform services requiring skills unique to the industry.

The OBBBA does not address how to treat deductions for employees of SSTBs who do not perform services unique to the field. The Treasury Department and the IRS have acknowledged this gap and indicated that guidance may be forthcoming, but there is no timetable for issuance.

In the meantime, Notice 2025-69 states a transition rule for this SSTB determination. Employees in "customarily and ordinarily" tipped occupations will be treated as working for a non-SSTB employer until January 1 of the year following issuance of final regulations. For example, because "Bartender" is on the list of occupations that "customarily and regularly" receive tips, a bartender who is employed by a theater to serve guests during intermission can qualify for the deduction despite being employed by an SSTB (under "performing arts"). Again, this could change in future regulations, but the change would be prospective only.

Key Considerations for Employers

Employers must separately report qualified tips, along with each qualifying employee's occupation, on Form W-2. Similar reporting rules apply for payments made to non-employees on Forms 1099-NEC. Only qualified tips that are separately accounted for are eligible for the deduction, making accurate recordkeeping critical.

To allow time for systems updates, the IRS provided transitional relief for tax year 2025. This relief eliminated penalties for noncompliance with Section 224's separate accounting requirement, but employers were still encouraged to provide employees with separate accountings of cash tips and occupation codes to help employees determine their deduction eligibility. Where employers elected to do so, these amounts could be calculated using any reasonable method described in Notice 2025-69. Further, employers could provide this information via online portals or additional secure written statements.

For 2026 and subsequent tax years, qualifying tips will need to be reported on Forms W-2. The IRS has released a 2026 Form W-2, under which qualified tips would be reported in Box 12 using the code "TP" ("Total amount of qualified tips") and Box 14b with a tipped occupation code.

Section 225: No Tax on Overtime

The OBBBA also added Section 225 to the Code, creating a separate federal income tax deduction for qualified overtime compensation received during taxable years 2025 through 2028. This deduction is capped at $12,500 per taxable year (or $25,000 for joint filers) and phases out for taxpayers with a MAGI above $150,000 (or $300,000 for joint filers).

What Is "Qualified Overtime Compensation"?

Qualified overtime compensation is limited to overtime pay that is required under the Fair Labor Standards Act ("FLSA"). FLSA-covered employees are required to be paid at least 1.5x their regular rate for hours worked over 40 in a workweek, subject to certain industry-specific exceptions. Overtime paid under state law, collective bargaining agreements, or employer policy beyond what the FLSA requires does not qualify for the deduction; and employees who are not covered by FLSA are not eligible.

The “qualified” amount is limited to the portion of FLSA-required overtime pay that exceeds the employee’s regular rate of pay—that is, the “half” in “time-and-a-half.” For example, if an eligible employee’s regular pay rate is $40/hour and they are paid $60/hour for overtime, only the $20 premium amount would qualify.

To prevent double-dipping, qualified overtime compensation excludes any amounts that are treated as qualified tips.

Key Considerations for Employers

As with qualified tips, employers must separately report qualified overtime compensation for the taxable year on an employee’s Form W-2. Although Section 225 refers to “employees,” businesses may also need to track and report overtime paid to certain non-employees on Forms 1099-NEC, due to differences between tax and FLSA definitions of “employee.” Again, only overtime compensation that is separately identified and accounted for may be used to calculate the deduction.

The IRS’s transitional relief for tax year 2025 also extended to qualified overtime compensation. Employers were not required to separately track or report qualified overtime compensation during this period. Employers that voluntarily chose to report these amounts, however, had flexibility to use any reasonable method described in Notice 2025-69 and were permitted to share the information with employees through Box 14 of their Forms W-2 or other secure methods.

On the 2026 Form W-2, employers would report qualified overtime compensation in Box 12 using the code “TT” (“Total amount of qualified overtime compensation”).

Proskauer Perspective

The tax saving opportunities presented by the OBBBA’s “no tax on tips” and “no tax on overtime compensation” hinge on accurate payroll classification and reporting. Given the complexity of the rules and the limited scope of the transitional relief, employers should carefully review their existing processes for tracking, classifying, and reporting tips and overtime compensation. Proactively evaluating payroll systems and providing clear guidance to affected workers can help reduce compliance risk following the transition year.

Proskauer's Compensation & Benefits and Tax teams are assisting employers in navigating compliance with these new tax obligations. Please contact a member of our teams with questions.

Related Professionals

- **Nicole Arslanian**
  Associate
- **Seth J. Safra**
  Partner
- **Tyler Forni**
  Associate