

H.R.1 Ends Taxes on Tips & Overtime: Employer Guide

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By Sarah Goodman



On July 4, 2025, President Donald J. Trump signed H.R.1—the *One Big Beautiful Bill Act*—into law following its narrow passage in the House of Representatives just days earlier. Touted as the Trump administration's marquee legislative victory ahead of the 2026 midterms, the Act makes headlines for many reasons. But for employers, two provisions demand immediate attention:

- **A new above-the-line tax deduction for qualified tip income, and**
- **A new above-the-line tax deduction for qualified overtime compensation.**

Both provisions are now law and will take effect starting with the 2025 tax year, bringing new complexities to wage practices, payroll reporting, and compensation strategy. Below is a summary of the legal and practical considerations employers need to know.

"No Tax on Tips:" Tax Deduction for Employees Receiving Qualified Tip Income

Section 70201 of the Act allows certain employees to deduct up to \$25,000 annually in qualifying tip income. The deduction is aimed at hospitality and service industry workers, but its implementation raises numerous legal and compliance considerations for employers.

Key Requirements

- **Eligibility Cap:** Deduction phases out beginning at \$150,000 in modified AGI (\$300,000 for joint returns).
- **Qualified tips must:**
 - be voluntarily paid by the customer (not mandatory service charges or auto-gratuities),
 - be paid in cash, by card, or through valid tip-sharing arrangements, and
 - be received in a qualifying occupation that customarily and regularly receives tips as of December 31, 2024.
 - The Treasury must publish a definitive list of qualifying occupations within 90 days.
- **Excluded Occupations:** Employees in law, accounting, finance, consulting, performing arts, and similar professions are categorically excluded from eligibility.

Reporting Requirements

- Employers must report:
 - Total cash tips received by the employee on Form W-2.
 - The employee's qualifying occupation (2025 approximations allowed, subject to Treasury guidance).

Employer Risks and Considerations

- Mischaracterization of wages as tips to secure a tax advantage may trigger IRS enforcement or wage-hour liability.
- Employers may consider changes to tip pooling or customer-facing tipping practices, but must:
 - remain compliant with FLSA tip pool rules, including exclusion of managers and supervisors,
 - avoid coercing tipping in non-traditional settings where it was not previously customary,
 - ensure 100% tip reporting is enforced among employees.

Until the Treasury issues regulations and the occupation list, employers should avoid restructuring wages to exploit this provision.

"No Tax on Overtime:" Deduction for Federally Mandated Overtime Compensation

Section 70202 of the Act allows employees to deduct up to \$12,500 (\$25,000 for joint filers) in FLSA-required overtime compensation. This deduction is limited in scope but may prompt employers to rethink how overtime is classified and compensated.

Qualified Overtime Compensation

- Applies only to overtime required under Section 7 of the FLSA (i.e., 1.5x pay for hours over 40 per week).
- Does not apply to:
 - Overtime required only by state law (e.g., California's daily overtime rules).
 - Overtime paid voluntarily under employer policy or collective bargaining agreements.
 - Payments already claimed as qualified tips.

Reporting Requirements

- Employers must separately report qualified overtime compensation on Form W-2.
 - For 2025, approximations are permitted under a reasonable method (to be defined by the Treasury).

Compliance Risks

With this new deduction, employers may be tempted to reengineer pay practices. However, doing so carries significant legal exposure:

Example 1: Reclassifying salaried exempt employees as nonexempt hourly employees, lowering base pay, and inflating overtime hours to maintain prior salary levels = FLSA violation if hours are not actually worked and accurately tracked.

Example 2: Reducing regular hourly rates for nonexempt employees while creating artificial overtime (e.g., setting an internal 30-hour threshold or applying double-time bonuses) = disallowed, as only FLSA-mandated overtime premiums qualify for the deduction.

The Treasury is authorized to issue regulations preventing abuse and wage reclassification. Employers who attempt to engineer “deductible overtime” without strict compliance will face regulatory scrutiny.

Practical Employer Guidance

The “no tax on tips” and “no tax on overtime” provisions will likely be popular with employees and heavily publicized during the 2025 W-2 season. But for employers, the changes bring regulatory complexity, legal risk, and potential downstream litigation.

What Employers Should Do Now

- Do not alter compensation structures prematurely.
 - Wait for Treasury regulations, especially the occupational list for tip eligibility.
- Ensure accurate wage and hour records.
 - All overtime-eligible employees must have their hours and regular rates carefully documented.
- Audit tip pool arrangements and ensure FLSA compliance.
 - Exclude ineligible participants, properly allocate tips, and enforce reporting discipline.
- Prepare to update payroll systems.
 - New W-2 fields for tip and overtime breakdowns will require reconfiguration.

Long-Term Strategy

- Employers considering reclassification of exempt employees, modification of pay rates, or introduction of creative incentive structures should engage qualified employment counsel.
- Wage-hour compliance and federal tax strategy must be aligned to avoid triggering enforcement by the IRS, DOL, or plaintiffs’ attorneys.

Final Thoughts

The tax benefits of H.R.1 may create new incentives for employees, but they also present a compliance minefield for employers. The risk of misclassification, improper reporting, or wage-hour violations is high, especially as employers rush to leverage perceived tax advantages.

Employers seeking to responsibly explore compensation adjustments in light of the “no tax on tips” and “no tax on overtime” deductions should consult with legal counsel familiar with FLSA compliance, payroll tax reporting, and employee classification issues.

Our labor and employment team is actively advising clients on how to navigate H.R.1's implementation. Contact us to schedule a strategy session or compliance audit.