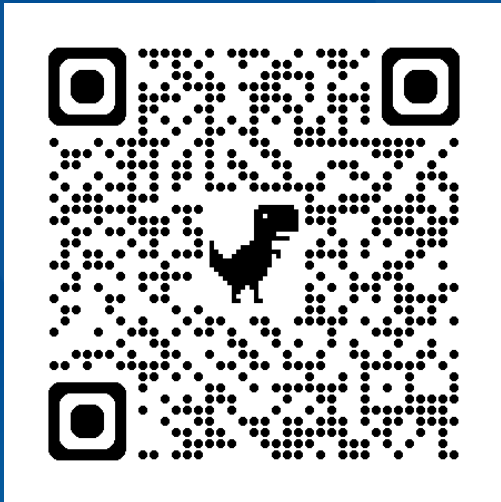


Just in Time: Implementing “No Tax on Overtime” for Government Employers

December 1, 2025



DISCLAIMER: EMPLOYERS HAVE REPORTING RELIEF IN 2025



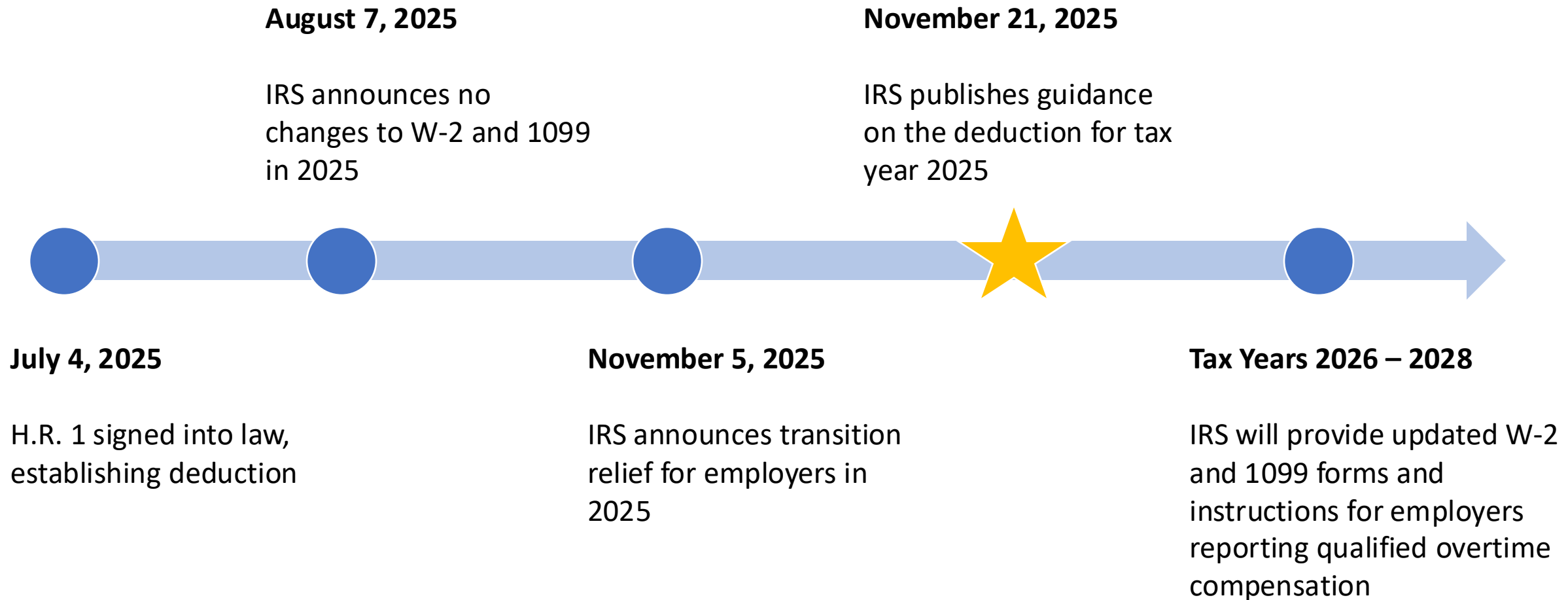
On November 5, the IRS announced **relief for employers in reporting** qualified overtime compensation on official tax statements (Notice 2025-62), like Form W-2

Employers may still choose to provide employees with estimates of qualified overtime pay this year, but **this is optional and at the discretion of the employer in tax year/calendar year 2025**

IRS Notice 2025-69 provides options for employees to calculate the deduction based on the type of overtime they receive

Employers will be required to provide employees with statements beginning in tax year 2026

IRS Guidance



Section 70202 of H.R. 1



- Section 70202 of H.R. 1 amended IRC §225 to allow individual taxpayers to deduct **qualified overtime compensation** from their taxable income
 - Above-the-line deduction
 - Retroactive to tax year 2025, **expires in 2028**
- Individual taxpayers can deduct up to \$12,500 in **qualified overtime compensation** from federally taxable income
 - For joint filers, the limit is \$25,000
- The deduction phases out at \$100 per \$1,000 of income in excess of \$150,000 in modified adjusted gross income
 - For joint filers, the deduction phases out at \$300,000 MAGI
 - *Ex.) An individual with a MAGI of \$200,000 in 2025 would be able to deduct \$7,500 this year*

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PUBLIC LAW 119–21—JULY 4, 2025

SEC. 70202. NO TAX ON OVERTIME.

(a) DEDUCTION ALLOWED.—Part VII of subchapter B of chapter 1, as amended by the preceding provisions of this Act, is amended by redesignating section 225 as section 226 and by inserting after section 224 the following new section:

“SEC. 225. QUALIFIED OVERTIME COMPENSATION.

“(a) IN GENERAL.—There shall be allowed as a deduction an amount equal to the qualified overtime compensation received during the taxable year and included on statements furnished to the individual pursuant to section 6041(d)(4) or 6051(a)(19).

“(b) LIMITATION.—

“(1) IN GENERAL.—The amount allowed as a deduction under this section for any taxable year shall not exceed \$12,500 (\$25,000 in the case of a joint return).

“(2) LIMITATION BASED ON ADJUSTED GROSS INCOME.—

“(A) IN GENERAL.—The amount allowable as a deduction under subsection (a) (after application of paragraph (1)) shall be reduced (but not below zero) by \$100 for each \$1,000 by which the taxpayer’s modified adjusted gross income exceeds \$150,000 (\$300,000 in the case of a joint return).

“(B) MODIFIED ADJUSTED GROSS INCOME.—For purposes of this paragraph, the term ‘modified adjusted gross income’ means the adjusted gross income of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933.

Qualified Overtime Compensation



Taxpayers can only deduct the **overtime compensation that exceeds their regular pay** and is required by section 7 of the Fair Labor Standards Act (FLSA) – this means **only FLSA-covered, non-exempt employees can claim the deduction**

Overtime or premium pay for certain work that is required by state law but is not covered/ineligible to be covered by FLSA is **NOT ELIGIBLE FOR DEDUCTION**

For **state and local government employees**, FLSA **generally** requires at least 1.5x regular rate of pay for any hours over 40 per week

- Only the “half” portion of time-and-a-half pay is eligible to be deducted
- Ex.) Employee A earns \$30/hour in regular wages and \$45/hour time-and-a-half. Only the FLSA-covered overtime amount of \$15 is deductible “overtime premium”



KEY DEFINITIONS



Qualified Overtime Compensation

*“overtime compensation paid to an individual required under **section 7 of the Fair Labor Standards Act of 1938** that is in excess of the regular rate at which such individual is employed”*

“Overtime Premium”

The amount of overtime pay that exceed regular pay (i.e. the half portion of time-and-a-half)

Qualified Overtime Compensation – Alternate FLSA



Only FLSA-covered overtime is qualified, but this includes alternate FLSA structures authorized by 29 USC § 207

State and local government employees: FLSA allows certain state and local government employees to receive compensatory time instead of cash overtime payments (§207(o))

- Compensatory time overtime is earned at a rate of 1.5x hours for each hour worked eligible for overtime payment (*dependent on work period structure*)
- Compensatory time is not limited to 40-hour work week structures and public safety employees are eligible

Public safety employees (police and firefighters): FLSA allows for 1.5x overtime to be calculated based on work periods of at least 7 days but less than 28 (§207(k))

- Overtime is due to when hours of numbers work bear same relationship to 212 (fire) or 171 (police) as the number of days in the work period bears to 28
 - *Ex.) Overtime is due after 106 hours worked in a 14-day workweek for fire fighters and 86 hours during a 14-day work period for police*

Hospitals and residential care workers: FLSA allows for 1.5x overtime to be calculated based on the “8/80” system that uses work periods of 14 consecutive days (§207(j))

- Overtime is due under the 8/80 system for hours that exceed 8 hours/day and 80 hours/14 days
- Non-discretionary bonuses and shift differentials are included in the rate of regular pay

Calculating Overtime Pay – Reasonable Methods



Overtime Situation	IRS Method	Deductible Amount
Employer pays 1.5x pay and your pay statement lists the “overtime premium” separately	“Method A”	Use listed overtime premium amount
Employer pays 1.5 x pay and pay stub shows only a combined “overtime total”	“Method B”	⅓ of the amount
Employer pays 2x pay and lists overtime premium separately	“Method C”	½ of that amount
Employer pays 2x pay but gives only a combined total	“Method D”	¼ of the amount
Regular rate boosted by bonuses	“Method E”	Use method B or D depending on overtime rate (1.5x rate, use B; 2x rate, use D)
Overtime scenario described in Methods A – E, no year-end statement, but hours + rates are known	“Method F”	Calculate qualified overtime (1.5x) considering your regular rate and hours more than 40 per work week
Overtime scenario described in Methods A – E, but police, fire, hospital, or public sector comp time	“Method G”	Apply alternative rule using methods A-F depending on overtime rate and information available



Method G – Alternate FLSA Overtime



Method G (IRS No. 2025-69, page 25) outlines how qualified, alternate FLSA-covered overtime compensation can be calculated in 2025.

- 1. Identify** which alternate FLSA rule applies (i.e. 207(k), 207 (j), 207(o))
- 2. Determine total FLSA overtime hours** using the relevant threshold
 1. Fire & Law Enforcement (207(k)): 7 to 28 day work periods
 2. Hospital & Residential Care workers (207(j)): 8/80 rule
 3. State & Local Compensatory Time: dependent on employee
- 3. Find or reconstruct overtime pay** using information on employer provided pay stubs using applicable reasonable method
 - If pay stub shows “FLSA overtime premium”: use it (Method A)
 - If only combined overtime wages are shown: divide by 3 (Method B)
 - If overtime is paid at double and the “premium” is listed: divide by 2 (Method C)
 - If overtime is paid at double time: divide combined amount by 4 (Method D)
- 4. Determine the FLSA overtime premium** (*this is always the extra ½ of the time-and-a-half overtime rate required by law*)



Compensatory Time



Government employees who earn compensatory time may only deduct the comp time if it is **paid out as wages** and appears on their W-2.

Compensatory time is deductible in the year it is paid, not the year it is earned.

Earning comp time = **not deductible**

Getting paid out for comp time in wages later = **deductible**

Calculating Overtime - Examples



Example 1: Individual A works in law enforcement and is paid \$15,000 of total annual overtime pay on a “work period” basis of 14 days that complies with 29 USC 207(k) of the FLSA.

Individual A may deduct \$5,000 in qualified overtime

Example 3: Individual C is a firefighter who earns \$28/hr and works 24-day work periods with a 182-hour limit. Individual C works 200 hours in a work period, meaning they worked 18 overtime hours.

Individual C earned \$756 in FLSA covered overtime

$$18 \times (\$28 \times 1.5) = \$756$$

Individual C may deduct the premium portion of \$252

$$18 \times (\$28 \times 0.5) = \$252$$

Example 2: Individual B works for a State or local government agency that gives compensatory time at a rate of one and one-half hours for each overtime hour worked under 29 USC 207(o). In 2025, Individual B was paid wages of \$4,500 with respect to compensatory time off taken in accordance with section 207(o).

Individual B may include \$1,500 of paid out compensatory time.

Example 4: Individual D is a city employee who earns comp time at 1.5 hours for each overtime hour. They earn 30 hours of comp time in 2024 but was paid out \$900 for the time at a rate of \$30/hour in 2025.

Individual D earned 10 “premium overtime” hours in 2024

$$30 - (30/1.5) = 10$$

Individual D may deduct the premium portion of \$150 paid out in 2025

$$10 \times (\$30) = \$300$$

Reporting Requirements



The Law

- H.R. 1 requires employers to:
 - Report qualified overtime compensation on appropriate tax forms like the employees' W2
 - Furnish employees with statements separately accounting for qualified overtime compensation
- H.R. 1 allows the Secretary of Treasury to provide employers with transition relief as it relates to these reporting requirements
 - **The IRS announced reporting relief for employers on 11/5**

In Practice (2026-2028)

- Many state and local governments provide overtime that is much generous than what is required by FLSA, or compensatory time
 - Only the overtime up to what FLSA requires is eligible to be deducted, meaning **employers will have to calculate FLSA-covered overtime premium separately** to be reported on official tax forms
 - **REMEMBER:** the IRS provided transitional relief in reporting for employers in 2025, meaning **this calculation is optional** this year
- Employers will be responsible for communicating these stipulations to employees seeking to deduct overtime compensation



If employers choose to report the amount of qualified overtime in 2025, you may do so using **Box 14 of Form W-2**



22222		a Employee's social security number		OMB No. 1545-0029			
b Employer identification number (EIN)			1 Wages, tips, other compensation		2 Federal income tax withheld		
c Employer's name, address, and ZIP code			3 Social security wages		4 Social security tax withheld		
			5 Medicare wages and tips		6 Medicare tax withheld		
			7 Social security tips		8 Allocated tips		
d Control number			9		10 Dependent care benefits		
e Employee's first name and initial		Last name		Suff.		11 Nonqualified plans	
						12a	
		13 Statutory employee		Retirement plan		Third-party sick pay	
		☐		☐		☐	
		14 Other		12b			
						12c	
						12d	
f Employee's address and ZIP code							
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name	

Form **W-2** Wage and Tax Statement
Copy 1—For State, City, or Local Tax Department

2025

Department of the Treasury—Internal Revenue Service



Frequently Asked Questions



“Recreation staff earn compensatory time instead of overtime. Will compensatory time be eligible for inclusion? If compensatory time is indeed eligible as deductible overtime, will it be eligible once it is earned or once it is used? “

Yes, but only when paid out as wages. Only the FLSA premium portion (1/2 portion of time-and-a-half) is eligible to be deducted in the year it is paid out at the regular rate that the employee earns on date of payment.

“We provide holiday premium pay, where police receive extra compensation for working on holidays instead of taking the holiday off. This is in addition to their base pay. How will this be treated?”

No, it is not qualified overtime since it is employer- or contract-provided and not tied to FLSA mandates for time worked over allowable hours in an FLSA-allowed work period. Overtime earned for working on a holiday could be considered qualified if it was earned for working over the allowable hours in the work period.

“We include non-working time, such as vacation & sick leave, in the calculation of police overtime per their collective bargaining agreement. Will the non-required leave of absences need to be removed from the calculation of qualified overtime?”

Yes, overtime pay for non-required leave of absences will need to be removed as they are not FLSA-required overtime payments. Method F outlines how qualified overtime can be calculated for police in accordance to alternate rules under §207(k).

“A significant portion of our firefighter's division receive over time pay for any hours worked outside of their normal schedule. They receive overtime rate of pay even if they have not reached their 50 hours. Does this overtime pay qualify for the deduction?”

No, it does not. Only FLSA-required overtime earned for working over 40 hours or over 53 hours in a 7-day work period.

QUESTIONS?



Scan here for IRS Notice 2025-69

***Email us your questions
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