Tax-Free Overtime: A Payroll Shift Trustees Should Be Watching Closely

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Last year, Congress passed the One Big Beautiful Bill Act (OBBBA) which was signed into law by the President on July 4, 2025. One significant component of the bill that may impact you is the "no tax on overtime" provision.

For an in-depth look at the new law and FLSA qualified overtime, please see our recent training on this topic.

ONLY FLSA-QUALIFIED OVERTIME IS REPORTABLE.

Among the key facts about the bill is the requirement that only FLSA-qualified overtime should be reported to employees. Qualified overtime constitutes hours worked over 40 hours in a standard 7-day work period. Many public safety employees may have a different work period and hour threshold. See an example below for more information.

Non-qualified overtime includes additional overtime that may be required by collective bargaining or employer policies and should be excluded from reporting. Some examples are:

- Hours worked over 8 hours in a day.
- Hours worked on holidays or weekends.
- Automatic overtime for "on call" or "call-out" time.
- Including time off (vacation, sick, personal, etc.) in the overtime calculation.

Also, only the premium (or "0.5") portion of the overtime pay is eligible for the tax deduction. There are currently no changes to the tax withholding tables. If your employees wish to modify their tax withholdings, they will need to complete a new form W-4.

OBBBA: No Tax on Overtime

2026 Planning

What This Means for Your Fund

(Trustee / Fiduciary Perspective)

Beginning in tax year 2026, qualified overtime will be reported in Box 12, Code TT of Form W-2. Trustees and board members should understand that this change introduces new compliance, reporting, and internal control considerations.

From a fiduciary standpoint, funds and participating employers should ensure:

1. Employees are properly classified as non-exempt under FLSA at the time of hire.

For additional guidance, refer to U.S. Department of Labor Fact Sheet #17A: Exemption for Executive, Administrative, Professional, Computer & Outside Sales Employees under the FLSA.

2. Payroll systems clearly distinguish between qualified and non-qualified overtime.

   Additional FLSA Resources:
   - Fact Sheet #23: Overtime Pay Requirements of the FLSA
   - Fact Sheet #8: Law Enforcement and Fire Protection Employees under the FLSA
   - Fact Sheet #7: State and Local Governments under the FLSA

3. The premium (“half-time”) portion of overtime is tracked separately from base wages.

4. Reporting procedures are reviewed to ensure accurate W-2 compliance beginning in 2026.

Improper classification or tracking may create compliance exposure or administrative inefficiencies for participating employers.

What This Means for Your Personal Tax Return

(Individual Trustee Perspective)

As individual taxpayers, trustees should also understand how this provision may affect their own returns.

Only the premium (“half-time”) portion of FLSA-qualified overtime is eligible for the tax deduction. The IRS has clarified that:

- Employers may opt out of reporting qualified overtime for tax year 2025.
- If an employer does not report qualified overtime, employees may calculate the deduction independently.

Qualified overtime amounts will appear on Form W-2 beginning in 2026.

OBBBA: No Tax on Overtime

Public Safety Employees

Section 7(k) of the Fair Labor Standards Act (FLSA) allows fire protection and law enforcement employees to receive overtime based on a designated "work period" of 7 to 28 consecutive days, rather than the standard 40-hour workweek.

For work periods of at least 7 but fewer than 28 days, overtime is required when hours worked exceed a proportional share of 212 hours (fire) or 171 hours (law enforcement) over a 28-day period.

For example:

- Fire personnel earn overtime after 106 hours in a 14-day work period.
- Law enforcement personnel earn overtime after 86 hours in a 14-day work period.
  See U.S. Department of Labor Fact Sheet #8 for additional detail.

Transition Relief

The IRS released two notices regarding the no tax on overtime provision of the One Big Beautiful Bill Act (OBBBA):

- Notice 2025-62: Allows employers to opt out of reporting qualified overtime for 2025. Reporting is still required for 2026 and beyond.
- Notice 2025-69: Provides guidance for employees to calculate their deduction for qualified overtime if their employer does not provide it.

If your team is struggling with the nuances of this new law, contact the payroll team at Lauterbach & Amen to discover how we can help simplify the process. Our team can be reached at **payroll@lauterbachamen.com**.

About the Author

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Tim Gavin, CPA, has over 20 years of accounting experience exclusively within the governmental sector. He has led audits, payroll services, financial reporting, and consulting engagements for municipalities, park districts, school districts, and other public entities, and has assisted clients in obtaining GFOA and ASBO certificates for excellence in financial reporting. He has been featured in several accounting industry publications, such as Accounting Today and CPA Practice Advisor.