

Memo

Date: January 6, 2026

To: Agency Payroll, Human Resources, and Accounting Staff

From: Dori Leland, Director, Enterprise Human Capital
Katie Karow, Director, Statewide Payroll Services

RE: Federal Reconciliation Bill (H.R. 1) and the Deductions for Tips and Overtime in 2025

Federal Reconciliation Bill (H.R. 1) 2025

The Federal Reconciliation Bill (H.R. 1) signed into federal law in July 2025 introduces new tax deductions that may impact employees who receive tips and Fair Labor Standards Act (FLSA) overtime pay. This memo outlines what to expect for the W-2s that will be provided in January 2026 for tax year 2025.

Tips Earned in 2025

Employees at an agency with the State of Minnesota, who have recorded qualified tips to be included in their pay, will find these amounts listed in box 7 and box 14OP of the 2025 W-2. **It is the employee's responsibility to work with a tax professional on determining the amount eligible for deductions when filing their annual tax return.**

- **New deduction:** Workers may be eligible for new deductions for tax years 2025 through 2028 if they received qualified tips. For tipped workers, the maximum annual deduction is \$25,000, which phases out for taxpayers with modified adjusted gross income over \$150,000 (\$300,000 for joint filers). “Qualified tips” are voluntary cash or charged tips received from customers or through tip sharing.
- Qualified tips must be paid in cash or an equivalent medium, such as check, credit card, debit card, gift card, tangible or intangible tokens that are readily exchangeable for a fixed amount in cash, or another form of electronic settlement or mobile payment application (excluding most digital assets) denominated in cash.
- Qualified tips must be received from customers or, in the case of an employee, through a mandatory or voluntary tip-sharing arrangement, such as a tip pool.
- Qualified tips must be paid voluntarily by the customer and not be subject to negotiation. Qualified tips do not include some service charges. For instance, in the case of a restaurant that imposes an automatic

18% service charge for large parties and distributes that amount to waiters, bussers and kitchen staff; if the charge is added with no option for the customer to disregard or modify it, the amounts distributed to the workers from it are not qualified tips.

Additional guidance for individual taxpayers that addresses how they can claim the deductions for qualified tips and qualified overtime compensation when they file their tax year 2025 returns is forthcoming from the IRS and will be found online at www.irs.gov.

FLSA Overtime Earned in 2025

For tax years 2025 through 2028, individuals who receive qualified overtime compensation may deduct the pay that exceeds their regular rate of pay (generally, the “half” portion of “time-and-a-half” compensation) that is required by the Fair Labor Standards Act (FLSA). **It is the employee’s responsibility to work with a tax professional on determining the amount eligible for deductions when filing their annual tax return.**

- **New deduction:** Effective for 2025 through 2028, individuals who receive qualified overtime compensation may deduct the “half” portion of “time-and-a-half” regular rate FLSA overtime¹ compensation. For employees eligible to receive overtime compensation, the maximum annual deduction is \$12,500 (\$25,000 for joint filers). This deduction phases out for taxpayers with modified adjusted gross income over \$150,000 (\$300,000 for joint filers).
- Generally, the FLSA requires that most employees in the United States be paid at least the federal minimum wage for all hours worked, and non-exempt employees must receive overtime pay at not less than time and one-half their regular rate of pay for all hours worked over 40 in a workweek.
- In addition to overtime pay, many employees who are non-exempt and eligible to use compensatory time in lieu of time off, may also claim the “half” portion (or one third) of comp time paid.
- As permitted by the H.R. 1, tax year 2025 will be a transition period for IRS enforcement and administration of the new information reporting requirements² for cash tips and qualified overtime compensation. MMB will not be providing overtime compensation as a separate category on the 2025 W2-s distributed to employees. This is necessary because our timekeeping and payroll system does not currently distinguish FLSA overtime from the other types of overtime employees are owed by collective bargaining agreement or compensation plan.

¹ Employees who were part of a bargaining unit in 2025 should review negotiated agreements pertaining to overtime calculations. Some Collective Bargaining Agreements (CBAs) require overtime to be paid before reaching 40 hours of time worked, which is the normal threshold for FLSA overtime.

² FLSA overtime is the only eligible deduction on 2025 taxes and identifying those hours are the responsibility of the employee.

- Employees seeking to take this deduction for 2025 wages are encouraged to work with their tax advisor or another tax professional to determine which overtime wages (if any) may be eligible for the deduction.

Additional guidance for individual taxpayers that addresses how they can claim the deductions for qualified tips and qualified overtime compensation when they file their tax year 2025 returns is forthcoming from the IRS and will be found online at www.irs.gov.

References

- MMB Bulletin – 10/16/2025: [Federal Reconciliation Bill \(H.R. 1\) - Update](#)
- IRS Fact Sheet – 7/14/2025: [One, Big, Beautiful Bill Act: Tax deductions for working Americans and seniors | Internal Revenue Service](#)
- IRS News Release – 9/19/2025: [Treasury, IRS issue guidance listing occupations where workers customarily and regularly receive tips under the One, Big, Beautiful Bill | Internal Revenue Service](#)
- IRS News Release – 11/5/2025: [Treasury, IRS provide penalty relief for tax year 2025 for information reporting on tips and overtime under the One, Big, Beautiful Bill | Internal Revenue Service](#)
- Federal Regulation for FLSA Overtime: [Fair Labor Standards Act: Overtime Compensation](#)
- Federal Regulation for FLSA Overtime and Government Employees: [Fair Labor Standards Act: Application to State and Local Government](#)
- Dept of Labor Fact Sheet for State and Local Governments FLSA: [Fact Sheet #7: State and Local Governments Under the Fair Labor Standards Act \(FLSA\) | U.S. Department of Labor](#)
- Dept of Labor Fact Sheet for Law Enforcement and Fire Protection FLSA: [Fact Sheet #8: Law Enforcement and Fire Protection Employees Under the Fair Labor Standards Act \(FLSA\) | U.S. Department of Labor](#)

Questions?

Agency Payroll, Human Resources, and Accounting staff should contact [Jody Dahl](#) in Statewide Payroll Services at 651-201-8206 or earncode.leave.mmb@state.mn.us with questions. [Dori Leland](#) is also available to answer questions regarding FLSA vs contract overtime.

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