Tax Insights
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IRS updates FAQs on qualified overtime compensation deduction

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In brief

What happened?

The IRS released Fact Sheet 2026-13 on August 6, updating its frequently asked questions (FAQs) on the individual income tax deduction for qualified overtime compensation, commonly referred to as "No Tax on Overtime." The Fact Sheet supersedes the January 2026 FAQs (Fact Sheet 2026-01), removes guidance applicable only to the 2025 tax year, and adds more detailed rules for 2026 through 2028.

Why is it relevant?

The guidance marks a shift from the 2025 transition period to a more formal reporting and compliance regime for 2026 and beyond. Starting in tax year 2026, employers and payors must separately report qualified overtime compensation on Form W-2 (box 12, code TT), Form 1099-MISC (box 14), or Form 1099-NEC (box 1d), as applicable.

Most importantly, for tax years after 2025, an employee generally may not use their own records to determine the deduction if the employer omits or understates qualified overtime compensation on Form W-2; instead, the employee must obtain a corrected Form W-2c. Form 4852 (*Substitute for Form W-2, Wage and Tax Statement*) or Form 1099-R (*Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*) will not satisfy the requirement. This is a significant development for individuals relying on employer or payor information reporting. Employers and payors that report qualified overtime incorrectly on Forms W-2 or 1099 and fail to correct may face information reporting penalties.

Action to consider

Employers and payors should review payroll, Human Resources Information System (HRIS), timekeeping, and year-end reporting processes to confirm they can identify Fair Labor Standards Act (FLSA) required overtime premiums for the 2026 calendar year. Even organizations that established guardrails for the 2025 transition year should note that these reporting requirements will be more stringently enforced going forward. Employers also should evaluate Form W-4 communications, as overtime wages remain subject to federal income tax withholding unless an employee provides an updated, valid Form W-4 reflecting the expected deduction.

In detail

Background

The One Big Beautiful Bill Act (the Act) created a temporary federal income tax deduction for individuals who receive qualified overtime compensation for calendar years 2025 through 2028. Qualified overtime compensation generally means overtime paid to an individual as required under Section 7 of the FLSA. Overtime pay remains taxable wages and compensation, and the deduction does not eliminate an employer's obligation to withhold, deposit, and report employment taxes.

Employers and payors face challenges defining qualified overtime compensation, implementing tracking mechanisms, mapping payroll systems for Form W-2 reporting, and managing employee communications. A key challenge is that employers may pay overtime in excess of FLSA requirements due to state law, collective bargaining agreements (CBA), or employer policy, but the deduction is tied to the FLSA-required amount.

What is newly clarified in Fact Sheet 2026-13?

Fact Sheet 2026-13 confirms that the deduction is not an exclusion from income and does not make overtime compensation exempt from employment taxes; qualified overtime compensation generally remains wages for federal income tax withholding, FICA, and FUTA purposes. The IRS clarifies that the deduction is available whether the taxpayer itemizes deductions or claims the standard deduction and is capped at $12,500 per individual return or $25,000 for a joint return, with phaseout beginning when modified adjusted gross income (MAGI) exceeds $150,000, or $300,000 for joint filers.

The Fact Sheet provides guidance on timing--qualified overtime compensation is generally treated as paid under the same principles used to determine when wages are paid for income tax withholding purposes. This is helpful for year-end payroll administration because deduction timing follows wage payment timing, not necessarily the workweek in which the overtime was earned.

Qualified overtime compensation: FLSA-only premium

The IRS confirms the core definition that qualified overtime compensation is the amount of overtime compensation required under Section 7 of the FLSA that exceeds the employee's regular rate. For a typical nonexempt employee paid at one and one-half times the regular rate for hours over 40 in a workweek, the "half" portion is the qualified overtime compensation amount (consistent with prior guidance).

The Fact Sheet expands the analysis by describing the FLSA workweek, hours worked, regular rate, and provides the formula FLSA hours worked in excess of 40 hours in a workweek × one-half × the employee's FLSA regular rate of pay. The regular rate includes all remuneration for employment unless excluded under the FLSA, and IRS directs employers to Department of Labor guidance for regular-rate and hours-worked issues. In one example, if an employer pays double time for FLSA overtime hours, only the amount minimally necessary to satisfy the FLSA overtime premium requirement is qualified overtime compensation.

Observation: The intersection between labor law and tax reporting remains a key operational challenge for employers. Employers must determine FLSA hours worked, the workweek, the regular rate, and the portion of premium pay required by Section 7. Those with state-mandated daily overtime, weekend or holiday premiums, double-time policies, CBA premiums, nondiscretionary bonuses, shift differentials, or alternative FLSA overtime methods may need additional payroll logic and documentation.

Reporting: the major new practical limitation

For tax years after 2025, the information reporting requirement becomes central to employee eligibility. Beginning in tax year 2026, employers must separately report qualified overtime compensation on Form W-2, box 12, code TT; in rare cases where a worker is an employee for FLSA purposes but is treated as an independent contractor for federal tax purposes, reporting may be on Form 1099-MISC, box 14, or Form 1099-NEC, box 1d. Employers must report the total qualified overtime compensation paid, even if it exceeds the employee's ultimate deductible amount after the statutory cap and MAGI limitation.

The most significant employee-facing change is that post-2025 deductions are limited by what is separately reported as qualified overtime compensation. After 2025, employees may not consider qualified overtime compensation exceeding the amount reported on Form W-2, box 12, code TT, in determining their deduction. If an employer omits or understates this amount, the employee must request a Form W-2c; if the employer is unwilling or unable to provide one, the employee may use only the reported amount— even if actually paid more. The IRS further states that Form 4852 cannot be used to satisfy the reporting requirement under Section 225(a).

Observation: For 2025, Notice 2025-69 allowed individuals to use reasonable methods and supporting records when employers did not separately report qualified overtime compensation. According to the Fact Sheet, this flexibility does not continue after 2025, placing greater pressure on employer reporting accuracy and more weight on payroll correction processes.

Corrections and penalties

If an employer discovers an error in Form W-2, box 12, code TT, it must file Form W-2c with the Social Security Administration and furnish the corrected form to the employee as soon as possible. The IRS also notes that incorrect Forms W-2 may be subject to information reporting penalties under Sections 6721 and 6722.

Federal income tax withholding

Employers may not reduce wages subject to federal income tax withholding merely because an employee expects to claim the qualified overtime compensation deduction, but an employee may provide a new Form W-4 estimating the expected deduction. The 2026 Form W-4 was updated to allow employees to account for the deduction in Step 4(b), and the Tax Withholding Estimator was updated accordingly. This requirement confirms and expands the observation that Form W-4 and Publication 15-T changes would be relevant to implementation. It also emphasizes the importance of employee communications because employees may confuse a deduction claimed on Form 1040 with an exclusion from payroll or withholding.

FLSA eligibility and exemptions

An employee must be both covered by the FLSA and not exempt from its overtime requirement to receive qualified overtime compensation. An individual who is ineligible for FLSA overtime cannot receive qualified overtime compensation eligible for the deduction, even if another law or a CBA provides overtime pay.

The takeaway

Fact Sheet 2026-13 provides the clearest IRS guidance to date on how the qualified overtime compensation deduction will operate after the 2025 transition year. Most importantly, for tax years after 2025, employees generally are limited to amounts separately reported as qualified overtime compensation on Form W-2, box 12, code TT, or Forms 1099-MISC and 1099-NEC, and must obtain a Form W-2c for omitted or understated amounts to properly claim the deduction. The updated FAQs provide employers with much-needed guidance to facilitate the required move from transition-year support to a 2026 compliance model encompassing FLSA-based pay classification, regular-rate calculation support, Form W-2/1099 mapping, tax withholding communications, employee education, and reporting correction procedures.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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