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Individual Federal Income Tax and Overtime Compensation

Introduction

The individual federal income tax applies to “all income from whatever source derived” unless exempted by law. Some lawmakers have introduced bills in the 119th Congress to exempt overtime compensation from the federal individual income tax, with the stated goals of increasing workers’ financial resources and reducing workforce shortages. This In Focus discusses policy parameters and considerations, recent proposals, and potential impacts of exempting overtime compensation from income taxation.

Policy Parameters and Considerations

Overtime compensation generally refers to premium pay received by employees whose work hours exceed a threshold amount in a given week. The federal Fair Labor Standards Act (FLSA) requires employers to pay nonexempt employees at least one-and-a-half times their regular rate of pay for hours worked over 40 hours in a week at a given job. While generally broad in coverage, the FLSA exempts several worker groups from its overtime provisions, including agricultural workers, certain truck drivers and other transportation workers, and certain salaried executive, administrative, and professional employees. Some workers may be entitled to overtime by state laws or employer policies.

A policy to exempt overtime compensation from federal income taxation could define such compensation in terms of the FLSA overtime requirement for covered, nonexempt workers. Broader definitions may include, for instance, any overtime compensation provided in accordance with federal law, state laws, and employer policies, or any compensation received for hours worked over 40 hours in a week.

Congress may also clarify if overtime compensation refers to all compensation received for overtime hours worked, or if it refers only to the premium amount paid on top of regular wages. For example, if an employee earns \$10 per non-overtime hour and \$15 per overtime hour, Congress could opt to exempt from federal income taxation all compensation received for overtime hours (\$15 per overtime hour worked in this example) or the premium only (\$5 per overtime hour worked).

To mitigate potential impacts on federal tax revenue or to target certain worker groups, Congress may limit the amount of the exemption or groups of taxpayers eligible for the exemption. For example, Congress may allow taxpayers to exempt overtime earnings up to a dollar amount per tax year (e.g., up to \$5,000 in overtime compensation) or limit the exemption to a percentage of non-overtime earnings (e.g., up to 15% of non-overtime compensation). Congress

may further limit the exemption to taxpayers with incomes below a certain threshold.

Current federal income tax provisions make no distinction between overtime earnings and non-overtime earnings. Consequently, these earnings are not disaggregated in wage and tax forms filed by employers (e.g., Form W-2). Proposals to exempt overtime earnings from taxable income may seek to establish recordkeeping and filing requirements needed to administer the new policy.

Potential Impacts

Absent other facts, exempting overtime earnings from taxable income is expected to decrease tax revenues and increase post-tax incomes of affected workers, as discussed below. Whereas the loss in federal tax revenue reduces resources available for federal spending, additional post-tax income can alleviate financial stress for some households and potentially lead to broader economic effects (e.g., if it leads to greater consumption that is not offset by reduced government spending).

Federal Tax Revenue

The Budget Lab at Yale estimated that allowing taxpayers to deduct overtime pay from income subject to the income tax could reduce revenues by \$866 billion through FY2034, under the assumptions that Congress does not extend the expiring provisions of P.L. 115-97 (known as the Tax Cuts and Jobs Act) and taxpayers do not change their behavior to maximize their tax benefit. The Joint Committee on Taxation estimated that a proposal in the House of Representatives’ reconciliation legislation to allow a deduction for the premium paid on overtime wages from 2025 through 2028 would reduce revenues by \$124 billion. The Penn Wharton Budget Model estimated the same policy would reduce revenues by \$184 billion.

The impacts of a policy change on federal tax revenue would depend on several factors. As previously discussed, policy design may place limits on the amount of overtime earnings exempted from taxable income or limit eligibility for such exemptions to certain taxpayers. In addition, employers’ and workers’ responses to the policy change may affect work hours, wages, and employment levels, with implications for tax revenue.

Employment and Hours of Work

Congress passed the FLSA in 1938 with the dual goals of protecting workers and stimulating the economy. The act’s overtime provisions aimed to discourage excessive hours by increasing employers’ wage costs when an employee works more than 40 hours in a week. These provisions also aimed to encourage hiring (e.g., where employers find it more

economical to hire an additional worker than to pay overtime rates to their existing workforce).

A policy to waive federal income tax on overtime earnings could have the opposite result by effectively raising the wage workers receive for overtime hours (via a reduction in income tax liability for overtime) without raising overtime costs to employers (if their overtime pay obligations under the FLSA remain unchanged). This change may increase workers' willingness to work overtime hours. If so, the policy may increase overtime hours, leading to longer workweeks for some full-time workers, and possibly putting downward pressure on hiring and employment levels in some workplaces. In occupations or places experiencing worker shortages, however, raising the effective overtime wage may help to reduce staffing challenges.

Some employers may seek to profit from the policy by adjusting compensation packages to recoup a portion of workers' reduced tax bill, thereby diminishing financial gains for workers. For example, some employers may marginally reduce wages (allowing them to reduce their wage bills) for existing employees or new hires, or adjust the timing and amount of pay raises.

Distributional Impacts

Workers eligible for overtime who owe no or little income tax would benefit little, if at all, from exempting overtime pay from the income tax. Those who face higher marginal tax rates—generally, those with higher incomes—would benefit more than those facing lower rates. While there is potential for gains to be felt by workers across the earnings distribution, exempting overtime pay from taxation could benefit some taxpayers with higher earnings more than those with lower earnings.

To the extent that such a policy defines eligible overtime compensation in terms of a workers' entitlement to overtime pay under the FLSA, workers' exemption status will be consequential. For example, Section 13(b)(27) of the FLSA, codified at 29 U.S.C. §213(b)(27), provides an exemption from the FLSA overtime provisions for "any employee employed by an establishment which is a motion picture theater." A cook or server employed by a movie theater that provides in-theater dining may be exempt from the FLSA overtime pay provisions (and therefore their overtime earnings would be ineligible for any new tax benefit), whereas an otherwise similar cook or server employed in a non-movie-theater establishment would not be exempt under Section 13(b)(27) and their overtime earnings for such work could be exempted from taxable income.

Exempting overtime pay from income taxation without other policy changes could also affect the value of other tax benefits. If exempting overtime pay eliminates some or all of taxpayers' income tax liability, they would lose some or all of their benefit from nonrefundable credits, which must be claimed against positive income tax liability. Omitting overtime from income taxation could also affect whether workers qualify for some refundable tax credits—such as the earned income tax credit (EITC) and the refundable

portion of the child tax credit, known as the additional child tax credit (ACTC)—which phase-in with earned income.

Recent Federal Proposals and State Laws

Federal lawmakers have introduced bills in the 119th Congress to exempt overtime compensation from the federal individual income tax, citing goals of reducing workforce shortages and increasing workers' financial resources.

The Keep Every Extra Penny Act of 2025 (H.R. 405) and the No Tax on Overtime Act of 2025 (S. 1046) would amend the Internal Revenue Code (IRC) to provide that gross income will not include overtime compensation required under Section 7 of the FLSA, codified at 29 U.S.C. §207. Another bill, the Overtime Pay Tax Relief Act of 2025 (H.R. 561), would amend the IRC to establish a deduction for an amount "equal to so much of any overtime compensation received by an individual as does not exceed 20 percent of such individual's other wages from the same employer for the taxable year." The deduction would not be allowed for a taxpayer whose adjusted gross income for the taxable year exceeds (1) \$200,000 in the case of a married couple filing jointly, (2) \$150,000 in the case of a head of household, or (3) \$100,000 in the case of any other individual.

Most recently, Section 110102 of the 2025 budget reconciliation legislation (as advanced by the House Committee on the Budget on May 18, 2025) proposes to establish a deduction for "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 (as used in such section) at which such individual is employed." The deduction would exempt certain tips received by the taxpayer and any compensation received by a "highly compensated employee" (as defined at 26 U.S.C. §414(q)(1)) or an individual who earned income in excess of the compensation threshold provided at 26 U.S.C. §414(q)(1)(B)(i) in the calendar year in which the taxable year begins.

At least one state has enacted legislation to exclude from state taxation amounts received as overtime compensation. In 2023, the Alabama legislature amended its tax code to exclude from an individual's taxable gross income amounts "received by a full-time hourly waged paid employee as compensation for work performed in excess of 40 hours in a week." This provision was revised in 2024 to exclude amounts "paid as overtime compensation in accordance with the U.S. Fair Labor Standards Act." The sponsor of the revision indicated that by referencing the FLSA, the exemption would now cover firefighters who may be paid overtime based on a work period other than a 40-hour week. The revision means that employees who are exempt from the FLSA's overtime pay requirement, but may have received overtime compensation pursuant to state law or some other arrangement, are now unable to exclude that amount from their gross income. The Alabama tax code provision expires on June 30, 2025.

Brendan McDermott, Analyst in Public Finance
Sarah A. Donovan, Specialist in Labor Policy

Jon O. Shimabukuro, Legislative Attorney

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