



The Deduction for Overtime Compensation

July 1, 2026

Introduction

Federal law generally requires workers to pay individual income taxes and payroll taxes on their earned income. The 2025 reconciliation law (P.L. 119-21) created a new income tax deduction of up to \$12,500 (\$25,000 for those married filing jointly) for certain overtime income in tax years 2025-2028. This In Focus discusses the policy parameters pertaining to this deduction and its potential effects on workers and federal revenues.

Overtime and the FLSA

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. Such groups include agricultural workers, certain truck drivers and other transportation workers, and certain salaried executive, administrative, and professional employees. Some exempted workers may still be entitled to overtime by state laws or employer policies.

The Budget Lab at Yale estimated that in 2023, roughly 98 million workers (excluding federal workers) were eligible for FLSA overtime pay, including 82 million wage earners and 16 million salaried workers. Of those amounts, the Budget Lab estimated that 12% of wage earners and 5% of salaried workers regularly or occasionally performed FLSA-covered overtime. These figures suggest that roughly 10-11 million workers regularly or occasionally performed FLSA-covered overtime work in 2023.

The Overtime Deduction

The individual federal income tax applies to “all income from whatever source derived” unless exempted by law. The 2025 reconciliation law created a new deduction for some overtime pay. From tax years 2025 through 2028, taxpayers can deduct up to \$12,500 (\$25,000 if married, filing jointly) of qualified overtime compensation from their income subject to tax. The deduction is reduced by \$100 for each \$1,000 the filer earned above \$150,000 (\$300,000 for those married filing jointly).

Qualified overtime compensation is the additional 50% of the regular rate of pay that employers must pay for overtime hours worked under Section 7 of the FLSA. Those eligible for overtime under state law or employer policies, but who are not covered by Section 7 of the FLSA, do not qualify for the deduction. Qualified overtime compensation does not include

the regular rate of pay for overtime hours worked or any qualified tip income.

For example, the regular rate of pay for an employee who earns an hourly wage of \$7.30, worked 50 hours in a given week, and received a \$50 production bonus would be

$$\frac{[\$7.30/\text{hour} \times 50 \text{ hours}](\text{hourly pay}) + \$50 (\text{production bonus})}{50 \text{ hours}} = \$8.30/\text{hour}$$

Such an employee would be entitled to their regular rate of pay of \$8.30/hour for 50 hours of work and \$4.15/hour (= $0.5 \times \$8.30$) for the 10 overtime hours, for total compensation of \$456.50 for the workweek. The overtime compensation income tax deduction would apply only to the overtime premium of \$41.50 (= $\$4.15/\text{hour} \times 10$ overtime hours).

Taxpayers can claim the overtime compensation deduction in addition to the standard deduction. Qualified overtime compensation is still subject to payroll taxes (such as for Social Security and Medicare hospital insurance). The deduction is available to taxpayers only if they have a work-eligible Social Security number and is disallowed for those married filing separately.

Claimants must have qualified overtime compensation accounted for separately on information returns, such as their W-2. The Internal Revenue Service (IRS) announced that it would waive penalties for failure to file correct information returns and payee statements for purposes of this deduction for tax year 2025 to facilitate the new deduction’s implementation.

Potential Impacts

Exempting overtime earnings from taxable income is expected to decrease tax revenues and increase post-tax incomes of affected workers, as discussed below. The loss in federal tax revenue reduces resources available for federal spending, but 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 Revenues

In December 2025, the Joint Committee on Taxation estimated that the new overtime deduction would reduce federal revenues by \$89.6 billion from fiscal year (FY) 2025 to FY2029. The annual cost is projected to be roughly \$22-\$23 billion annually from FY2026 through FY2028, the fiscal years entirely covered by the temporary deduction.

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).

Allowing workers to deduct overtime earnings from their income subject to tax could have the opposite result. The deduction effectively raises the wage workers receive for overtime hours (via a reduction in income tax liability for overtime) without raising overtime costs to employers. 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 they may adjust the timing and amount of pay raises.

Distributional Impacts

Workers eligible for overtime who owe no or low income tax 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—benefit more than those facing lower rates. While workers across the income spectrum could potentially gain from the deduction, exempting overtime pay from taxation could benefit some taxpayers with higher earnings more than those with lower earnings.

Given that the deduction defines eligible overtime compensation in terms of a worker's entitlement to overtime pay under the FLSA, workers' exemption status is 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 the income tax deduction), 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 deducted from taxable income.

Deducting overtime pay from taxable income without other policy changes could also affect the value of other tax benefits.

If deducting overtime pay eliminates some or all of a taxpayer's income tax liability, they could lose some or all of their benefit from nonrefundable credits, which must be claimed against positive income tax liability.

The overtime deduction does not impact a taxpayer's federal adjusted gross income or earned income. This design means that the credit does not change the taxpayer's income in a manner that affects their eligibility for refundable tax credits that phase in with earned income—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)—or for other social benefits that base eligibility on such measures.

Usage for Tax Year 2025

The Department of the Treasury reported in June 2026 that more than 29 million individual income tax filers claimed the overtime deduction in tax year 2025. This number represents roughly 20% of the returns that the IRS reported it had received for the 2025 tax year as of May 8, 2026, and exceeds the 10-11 million workers that the Yale Budget Lab estimated worked some FLSA overtime in 2023. The Department of the Treasury also reported that the average amount deducted was greater than \$3,100. These figures could change as individuals amend their 2025 tax returns or continue to file after the April 15 deadline.

The number of claims could be higher than expected for several reasons. First, it is possible that early estimates of the number of workers claiming overtime were inaccurate. Second, it could be that workers adjusted their work behavior once the deduction was announced to earn more tax-exempt overtime income. Third, taxpayers may be claiming the deduction inappropriately. Taxpayers could be claiming it for overtime work that is not qualified overtime compensation. Some may also claim the deduction fraudulently. The waiver of penalties for inaccurate information returns and payee statements for tax year 2025 may facilitate confusion or improper claims among taxpayers and prevent the IRS from identifying inappropriate claims.

Recent Proposals to Expand Deduction

Since passage of the 2025 reconciliation law, federal lawmakers have introduced several bills to expand the exemption to at least some compensation that is not covered by Section 7 of the FLSA. These include H.R. 4740 and H.R. 5475 (both titled the No Tax on Overtime for All Workers Act) and H.R. 6900 (the American Affordability Act of 2025). Each of these bills would expand the deduction to cover work in excess of 40 hours per week performed pursuant to an agreement entered into ahead of time by the employer and employee. H.R. 4740 would limit this expansion to only agreements that are collective bargaining agreements.

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IF13263

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