

New Income Tax Deductions for Tax-Free Tips and Overtime

BY ADAM N. MICHEL

In July 2025, President Trump signed a large tax and spending package into law. Among the many new additions to the tax code are two income tax deductions for tip and overtime income. Both are available from 2025 to 2028. This brief provides an overview of these new provisions, their economic and budgetary effects, and recommendations for Congress when they expire.

There is no principled reason to treat income from overtime or tips differently from any other labor income. Narrow carve-outs shrink the tax base, treat similar taxpayers differently, complicate compliance, and increase the economic costs of the income tax. A broad-based, low-rate tax system that eliminates provisions such as the new deductions for tips and overtime would impose fewer unnecessary economic costs and promote equal treatment under the law.

THE COST OF NEW DEDUCTIONS

The 2025 budget reconciliation act, often called the One Big Beautiful Bill Act, reduced taxes from the current law baseline by \$4.5 trillion over 10 years. The majority of the tax reduction comes from extending the expiration date of the tax cuts passed in 2017. Two relatively minor provisions— income deductions for tips and overtime—have received outsized political coverage because they fulfill key Trump campaign promises. The two provisions reduce revenue by a combined \$121 billion, about 3 percent of the total tax cut, over 10 years. Both deductions took effect January 1, 2025, and are therefore available retroactively for the tax year in which the legislation was passed. The deductions expire after 2028.

Figure 1 shows the annual budgetary effect of the deductions for tips and overtime under current law and in a scenario where these deductions are made permanent. If



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the deductions are extended, the combined 10-year revenue reduction would increase to \$310 billion.¹

THE BASICS OF THE TIPS AND OVERTIME DEDUCTION

The tips deduction allows eligible taxpayers to deduct up to \$25,000 in tipped income from taxable income each year. The overtime deduction applies to the first \$12,500 for single taxpayers (\$25,000 for married couples filing jointly) of the additional bonus pay above the base hourly rate.² The deductions are above the line, so they are available to taxpayers who claim the standard deduction and to those who itemize their deductions. Both deductions phase out at a 10 percent rate for single taxpayers with a modified adjusted gross income over \$150,000 (\$300,000 for married couples filing jointly).

The standard deduction for single taxpayers in 2025 is \$15,750 (\$31,500 for married couples filing jointly), which means anyone making less than that amount will not

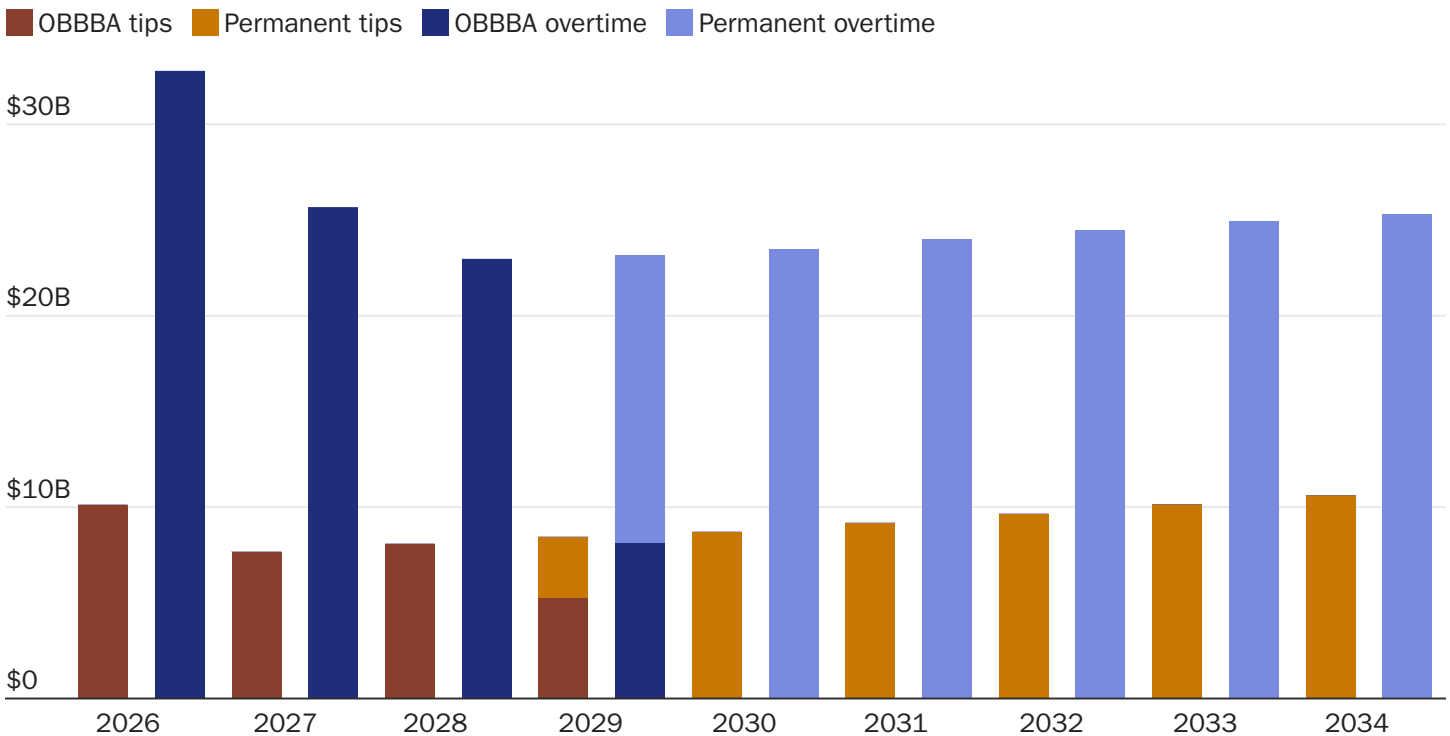
benefit from an additional deduction because they already pay no income tax. Above the standard deduction, the value of the tip and overtime deduction depends on the taxpayer's tax bracket. Deducting \$1,000 in tips saves \$100 in taxes for someone in the lowest 10 percent bracket (\$0–\$11,925 in taxable income for a single taxpayer) and \$220 for someone in the 22 percent bracket (\$48,476–\$103,350 in taxable income for a single taxpayer).³ The full \$25,000 deduction would reduce the taxes of someone in the 22 percent tax bracket by \$5,500. Major parameters for the tips and overtime deductions are summarized in Table 1.

Estimates from the Tax Policy Center indicate that the new tip and overtime deductions result in average tax savings that are far less than the potential maximums but still significant for those who benefit. The roughly 3 percent of tax returns projected to claim the tips deduction in 2026 will receive an average tax cut of about \$1,370. Figure 2 shows that, as a share of after-tax income, the tips deduction broadly benefits those in the middle of the income distribution. The overtime deduction will be claimed

Figure 1

No tax on tips and overtime would reduce revenue by \$310 billion

Tips and overtime, billions of US dollars



Source: "Effects on Deficits and the Debt of Public Law 119-21 and of Making Certain Tax Policies in the Act Permanent," Congressional Budget Office, August 4, 2025.

Note: OBBBA = One Big Beautiful Bill Act.

by about 9 percent of tax returns, cutting their taxes by \$1,440 on average. The overtime deduction produces the largest increases in after-tax income for taxpayers in the middle and upper portions of the income distribution.⁴

These provisions also add to the already large number of tax deductions and credits that shield vastly uneven amounts of income from taxation based on family size and childcare arrangements. For example, a married couple with

two children, childcare expenses, and \$25,000 in either tip or overtime income will benefit from \$105,500 in tax-free income in 2026. The same couple without kids and with no tip or overtime income pays taxes on income above \$32,200. If both families earn \$150,000, the second couple will pay \$10,000 more in taxes in 2026.⁵ This inequity is driven by many features of the tax code and worsened by the new provisions in the One Big Beautiful Bill Act.

Table 1

Parameters for tips and overtime deductions under the OBBBA (2025–2028)

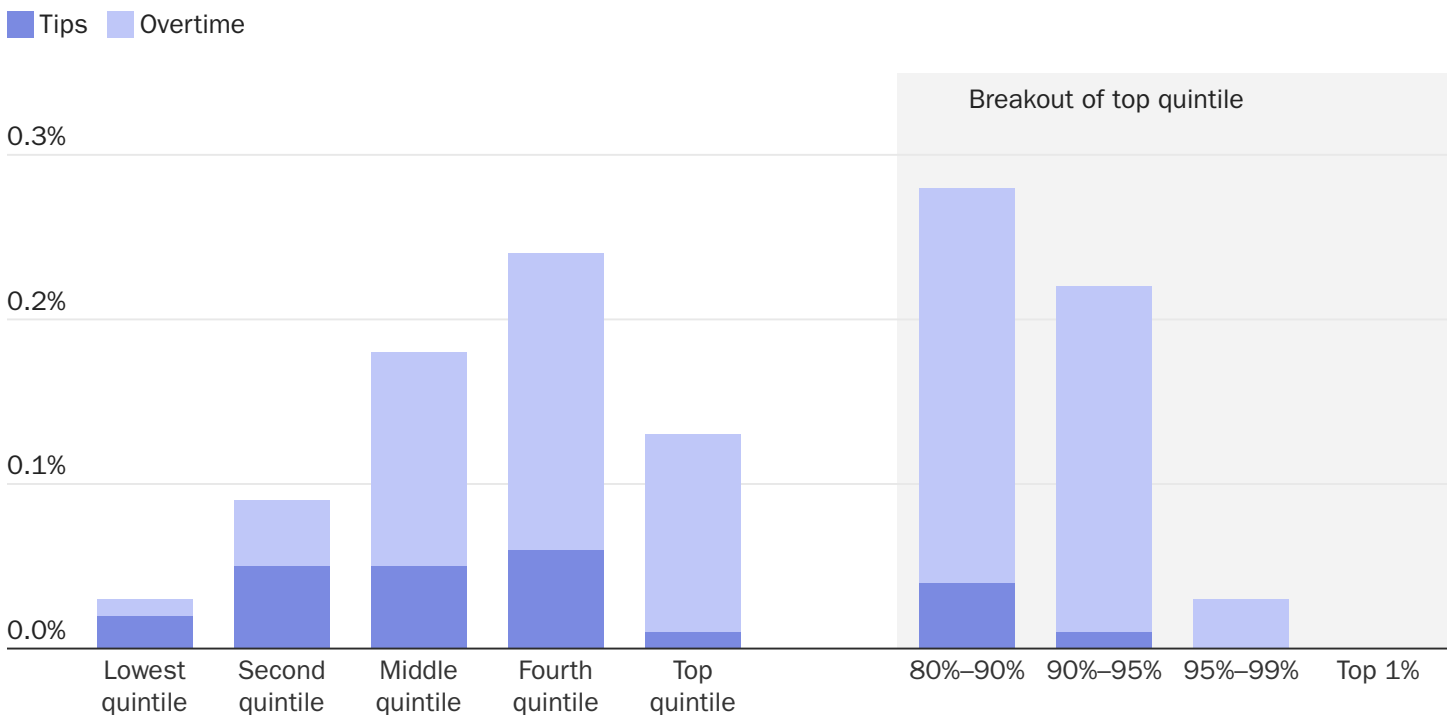
Deduction	Max amount (single/MFJ)	Phaseout starts (single/MFJ)	Phaseout ends (single/MFJ)	Max tax cut, 22% bracket (single/MFJ)
Tips	\$25K/\$25K	\$150K/\$300K	\$400K/\$550K	\$5.5K/\$5.5K
Overtime	\$12.5K/\$25K	\$150K/\$300K	\$275K/\$550K	\$2.75K/\$5.5K

Notes: The 22% bracket includes \$48,476–\$103,350 of taxable income for single filers (double for MFJ). MFJ = married filing jointly; OBBBA = One Big Beautiful Bill Act.

Figure 2

Every income group benefits from tips and overtime deductions

Percentage of after-tax income by expanded cash income, 2026



Sources: “T25-0245—Tax Benefit of the Deduction for Qualified Tips, by Expanded Cash Income Percentile, 2026,” Tax Policy Center, Urban Institute and Brookings Institution, July 31, 2025; and “T25-0247—Tax Benefit of the Deduction for Qualified Overtime (OT) Compensation, by Expanded Cash Income Percentile, 2026,” Tax Policy Center, Urban Institute and Brookings Institution, July 31, 2025.

Who Benefits from the Tips Deduction?

In addition to the income limits, the tips deduction is only available to occupations that “customarily and regularly received tips” before 2025.⁶ In September 2025, the Treasury Department issued a proposed rule that lists 68 eligible occupations and clarifies other limits.⁷ The list includes the obvious categories, such as waiters, bartenders, gambling dealers, and cosmetologists. However, it also includes unexpected occupations, such as digital content creators and home services provided by electricians, plumbers, and locksmiths. According to the Treasury, less than 1 percent of these nontraditionally tipped occupations reported any tipped income. On average, 70 percent of waiters, bartenders, dealers, and cosmetologists received tips, which account for more than half their reported wages.⁸

Based on the proposed occupations list, the Treasury estimates that more than 10 million tax returns will claim a tips deduction in 2026.⁹ This is more than double the private-sector estimates for eligible tipped workers, which use narrower traditional definitions of customarily tipped occupations.¹⁰ The Joint Committee on Taxation does not provide details on the assumptions underlying its official revenue estimates, but if similar definitional differences exist in its estimates, Congressional revenue estimates could undercount the revenue loss by more than 100 percent.

The rule also stipulates that tips must be voluntary and in cash or cash equivalents, such as casino chips or Venmo payments. Automatic gratuities are ineligible for the deduction “unless the customer is expressly provided an option to disregard or modify it without consequence.”¹¹ This requirement follows similar guidance for the employer payroll tax credit for reporting tipped income.¹²

The final major restriction is the law’s limit for occupations that are also considered a “specified service trade or business” (SSTB).¹³ The SSTB designation is defined in another section of the tax code (Section 199A), which includes many higher-income service businesses, such as those established by doctors, lawyers, finance professionals, and athletes.¹⁴ The definition also includes performing artists. These SSTB occupations are excluded from the tips deduction.¹⁵ To qualify for the deduction, a worker must be in an eligible occupation and work for an eligible, non-SSTB employer.

This restriction also interacts awkwardly with 1099 independent contractors. Because contractors are treated as

operating their own business for tax purposes, their personal occupation becomes the relevant test for SSTB status. That means many tipped workers classified as independent contractors could be excluded even if they perform the same work as eligible W-2 workers employed by a non-SSTB entity.¹⁶

Economic Distortions of the Tips Deduction

Congress placed important guardrails on the tips deduction to mitigate the most obvious abuses, such as the wholesale recharacterization of guaranteed wages as tips. But anti-abuse rules come with trade-offs: added complexity, new inequities, and incentives to reorganize around the lines Congress has drawn.

First, two workers in nearly identical jobs may be treated very differently depending on their employer’s industry classification. Service workers employed by firms deemed SSTBs are barred from the deduction, even if their work is indistinguishable from that of eligible employees elsewhere. For example, a bartender who works for an SSTB-designated theater company is ineligible for the tips deduction, while a bartender employed by a restaurant is eligible. This could push firms to restructure their operations. For instance, theaters might staff bartenders or waiters through separate companies to qualify for the benefit, or they might raise wages to offset the lost tax break.

Second, the deduction’s distinction between voluntary tips and automatic gratuities will likely change payment practices. Expect new fine print on service charges that allows customers to nominally opt out, ensuring that the payments qualify. Tipping will become more widespread in sectors where it was previously rare. Home-service providers such as electricians, plumbers, and locksmiths may shift part of their billing toward a tipping model. Digital creators on YouTube, Patreon, OnlyFans, and Substack may find it easier to reframe subscriptions or pledges as tips.¹⁷ And a prohibition on the tips deduction for amounts received for “pornographic activity” will require new, difficult-to-administer IRS definitions of pornography.¹⁸ (Maybe they will know it when they see it?)¹⁹

These incentives will accelerate the already pervasive trend of “tipflation” by expanding tipping norms into new industries.²⁰ They will also create additional compliance costs as firms and workers navigate SSTB classifications, restructured contracts, and new reporting rules. Rather than

increasing work hours or boosting productivity, the tips deduction is more likely to encourage the recharacterization of existing income, incentivize administrative gaming, and cause paperwork burdens.

In short, while the deduction prevents the most blatant forms of abuse, it also incentivizes costly reorganizations with little chance of producing meaningful economic gains.

Who Benefits from the Overtime Deduction?

The overtime deduction applies only to workers whose additional pay qualifies as “overtime compensation” under the Fair Labor Standards Act (FLSA) and may therefore exclude some overtime mandated by states or by labor contracts.²¹ The FLSA generally requires employers to pay nonexempt employees 1.5 times their regular hourly rate for time worked over 40 hours each week. Additionally, workers must fulfill three criteria to qualify for the exemption from FLSA overtime: they must hold a white-collar occupation that involves performing executive, administrative, or professional duties; they must be salaried; and their salary must be over \$35,568 per year.²² Independent contractors are outside the scope of FLSA coverage and are therefore ineligible for the overtime deduction. The deduction also disqualifies entire categories of workers explicitly exempt from the FLSA by statute, such as movie theater employees, as well as occupations governed under separate federal labor regimes, including flight attendants, pilots, and many rail workers.²³

A Yale Budget Lab analysis finds that roughly 98 million American workers (over 60 percent of the total labor force) were eligible for FLSA overtime in 2023, but only “8% of hourly workers and 4% of salaried workers work FLSA-qualified overtime on a regular basis.”²⁴ In practice, overtime is highly concentrated in specific sectors, such as manufacturing, health care, transportation, and public safety.

Economic Distortions of the Overtime Deduction

As an unintended consequence, narrowly targeted incentives can distort how hours are scheduled, how additional after-tax compensation is divided between workers and employers, and how workers respond to these practices.

The economic value of the overtime deduction is determined by how wages adjust. In competitive labor markets, tax cuts are typically shared between workers and employers, depending on each party’s bargaining power and the elasticity of labor supply.²⁵ If workers have little leverage or if overtime is mandatory, firms may capture part of the benefit by lowering base wages or by offering fewer other forms of compensation. Conversely, in sectors facing labor shortages, employers may need to pass through most of the tax savings to workers as higher after-tax pay.²⁶ The result is an uneven and unpredictable distribution of benefits across industries and income levels.

The deduction may also change the timing of work and employee classifications. Because the deduction applies to overtime pay earned in a single week, workers are incentivized to rearrange hours to maximize the overtime classification. Employees might prefer to concentrate hours into fewer weeks to qualify for the tax benefit. All things being equal, employees will also prefer overtime-eligible positions over salaried equivalents. Firms will still prefer to limit overtime pay but may allow some workers with higher bargaining power to reshuffle hours or set up work arrangements to exploit the deduction.

To the extent that the deduction affects workers who can choose their hours, it could modestly increase labor supply at the margin. Some employees might be more willing to work additional shifts if the after-tax reward for overtime is higher. However, the magnitude of this response is likely small. Overtime hours are often constrained by employer needs, not merely by worker preference. The deduction also phases out for higher-income households, so many upper-middle-income workers will see little or no additional incentives.

In combination, these effects suggest that the overtime deduction will have only a limited influence on total hours worked and overall productivity. Most of its budgetary cost will come from existing work patterns while adding another layer of administrative complexity and labor bargaining to an already complex tax and labor code.

REFORMS

The tips and overtime deductions move the tax code in the wrong direction, narrowing the tax base, adding complexity, and creating new inequities between workers performing

similar jobs. A fundamental principle of sound tax policy is neutrality: Income should be taxed once at a single low rate, regardless of how it was earned, what industry it came from, or if it is base or variable pay. The new tips and overtime deductions violate this principle.

Rather than layering new deductions into the tax code, Congress should focus on simplifying and broadening the tax base while reducing marginal tax rates. A broad-based, low-rate system, such as a flat tax, would allow workers to keep more of each additional dollar they earn without needing to navigate a maze of arbitrary carve-outs. Under such a system, all labor income would be treated equally, removing the need to distinguish between base pay, bonus pay, or service tips.

Eliminating narrow deductions would also reduce compliance burdens and limit opportunities for tax avoidance. Employers would no longer need to track and certify eligibility for dozens of occupations or redesign payroll systems to separate qualifying and nonqualifying income. Workers would face clearer incentives: More work always leads to higher after-tax income, regardless of how that income is classified.

Eliminating taxes on tips and overtime would reduce federal revenue by roughly \$30 billion a year, about 1.1 percent of total income tax receipts.²⁷ According to our calculations, this implies that marginal income tax rates could be roughly 1 percent lower (or less than half a percentage point lower for the top rate of 37 percent) if Congress wanted to keep revenue unchanged and replace these new income deductions with lower tax rates. In the context of \$2.6 trillion in federal income tax revenue generated in 2025, \$30 billion is a relatively small reduction. However, many seemingly small deductions and exclusions add up to significant revenue loss and complexity. For example, the 37 largest income tax exclusions and deductions, including for tips and overtime, reduce income tax revenues by almost \$700 billion each year.²⁸

We calculate that closing \$700 billion in tax loopholes could raise enough revenue to reduce marginal tax rates by about 27 percent on average, implying top marginal income tax rates of 27 percent (down from 37 percent) and bottom rates of 7 percent (down from 10 percent). Because the economic cost or deadweight loss of a tax increases exponentially with the tax rate, a 27 percent decline in tax rates reduces the economic damage of the tax by almost 50 percent.²⁹ Plausible estimates suggest that the deadweight loss of the current income tax exceeds 4 percent of gross domestic product (GDP).³⁰ If policymakers broaden the tax base by eliminating provisions that exempt tips and overtime pay from taxation and that provide other similar deductions, and if they use the increased revenue to cut tax rates by 27 percent, they could reduce the economic drag of the income tax by roughly \$600 billion.

Congress can replace narrow, distortionary carve-outs with a simpler, more neutral tax system that reduces disincentives to work, minimizes economic distortions, and delivers far greater gains to workers than temporary deductions for tips and overtime.

CONCLUSION

The new deductions for tips and overtime illustrate how narrowly tailored tax preferences, no matter how well-intentioned or politically popular, ultimately erode the integrity of the tax system. Rather than encouraging additional work, they primarily reward the reclassification of income, impose new compliance burdens, and distort work decisions. Their temporary nature only compounds the uncertainty for workers and employers, inviting costly adjustments that may expire in only a few short years. When the provisions expire after 2028, Congress should resist calls to extend them. A cleaner tax code that treats all income neutrally, applies a broad base, and relies on lower marginal rates is a more durable, pro-growth alternative.

NOTES

1. “Effects on Deficits and the Debt of Public Law 119-21 and of Making Certain Tax Policies in the Act Permanent,” Congressional Budget Office, August 4, 2025.
2. By law, overtime pay is 1.5 times the worker’s base hourly wage. The overtime deduction applies only to the 50 percent additional pay. For example, if an employee earns \$20/hour and works 50 hours in a week, they receive 40 hours at \$20 (\$800) and 10 overtime hours at \$30 (\$300). Only the \$10/hour premium for those 10 hours (\$100) is eligible for the new deduction.
3. Taxable income is adjusted gross income minus deductions. A single taxpayer with \$30,000 in adjusted gross income would claim the \$15,750 standard deduction and would have \$14,250 in taxable income.
4. “T25-0245—Tax Benefit of the Deduction for Qualified Tips, by Expanded Cash Income Percentile, 2026,” Tax Policy Center, Urban Institute and Brookings Institution, July 31, 2025; and “T25-0247—Tax Benefit of the Deduction for Qualified Overtime (OT) Compensation, by Expanded Cash Income Percentile, 2026,” Tax Policy Center, Urban Institute and Brookings Institution, July 31, 2025.
5. The four-person family pays \$5,340 in taxes. The married couple pays \$15,340.
6. Occupations That Customarily and Regularly Received Tips; Definition of Qualified Tips, 90 Fed. Reg. 45340 (September 22, 2025).
7. Occupations That Customarily and Regularly Received Tips; Definition of Qualified Tips, 90 Fed. Reg. 45340 (September 22, 2025).
8. Occupations That Customarily and Regularly Received Tips; Definition of Qualified Tips, 90 Fed. Reg. 45340 (September 22, 2025).
9. Occupations That Customarily and Regularly Received Tips; Definition of Qualified Tips, 90 Fed. Reg. 45340 (September 22, 2025).
10. Ernie Tedeschi, “The ‘No Tax on Tips Act’: Background on Tipped Workers,” Budget Lab, Yale University, June 24, 2024.
11. Department of the Treasury and Internal Revenue Service, proposed regulations, Occupations That Customarily and Regularly Received Tips; Definition of Qualified Tips, 90 Fed. Reg. 45340 (September 22, 2025).
12. Rev. Rul. 201218, 201226 I.R.B.
13. An Act to Provide for Reconciliation Pursuant to Title II of H. Con. Res. 14, Pub. L. No. 119–21, 139 Stat. 72 (July 4, 2025).
14. Specified Service Trades or Businesses and the Trade or Business of Performing Services as an Employee, 26 C.F.R. § 1.199A5 (amended 2025), qualified trade or business determination.
15. The IRS has offered transition relief for the SSTB requirement until January 1 of the first calendar year following the issuance of final regulations. Office of Associate Chief Counsel, “Guidance for Individual Taxpayers Who Received Qualified Tips or Qualified Overtime Compensation in 2025,” Notice 2025-69, Internal Revenue Service.
16. Andrew Lautz, “Explaining the New ‘No Tax on Tips’ Rules Proposed by the IRS,” Bipartisan Policy Center, September 26, 2025.
17. The proposed regulations explicitly exclude pornography and prostitution. Department of the Treasury and Internal Revenue Service, proposed regulations, Occupations That Customarily and Regularly Received Tips; Definition of Qualified Tips, 90 Fed. Reg. 45340 (September 22, 2025).
18. Occupations That Customarily and Regularly Received Tips; Definition of Qualified Tips, 90 Fed. Reg. 45340 (September 22, 2025).
19. Trevor Sikes, “Will IRS Know Pornography When It Sees It for Tips Deduction?,” *Tax Notes Today Federal*, Tax Notes, October 15, 2025.
20. Alex Muresianu, “Frustrated with Tipping? No Tax on Tips Could Make It Worse,” Tax Foundation, July 23, 2024.
21. An Act to Provide for Reconciliation Pursuant to Title II of H. Con. Res. 14, Pub. L. No. 119–21, 139 Stat. 72 (July 4, 2025).
22. Sarah A. Donovan, “The Fair Labor Standards Act (FLSA): An Overview,” Congressional Research Service, R42713, updated March 8, 2023.
23. 29 U.S.C. § 213.
24. “‘No Tax on Overtime’ Raises Questions About Policy Design, Equity, and Tax Avoidance,” Budget Lab, Yale University, September 17, 2024.

25. Robert McClelland and Shannon Mok, “A Review of Recent Research on Labor Supply Elasticities,” Congressional Budget Office Working Paper no. 2012-12, October 2012.
26. Aaron Till, “The 2025 Tax Bill: No Taxes on Overtime, Simplified,” Bipartisan Policy Center, June 16, 2025.
27. “Effects on Deficits and the Debt of Public Law 119-21 and of Making Certain Tax Policies in the Act Permanent,” Congressional Budget Office, August 4, 2025.
28. “Tax Expenditures Fiscal Year 2026,” Office of Tax Analysis, Department of the Treasury, November 27, 2024.
29. Assuming deadweight loss rises with the square of the tax rate, a 27 percent reduction in rates reduces dead weight loss by roughly $1 - 0.73^2 = 0.47$, or 47 percent.

30. Edgar Browning estimates that the average deadweight loss of the income tax is 40 cents per dollar raised and another 10 cents for tax compliance costs. Individual income tax receipts were 8.4 percent of GDP in 2024. Applying an average deadweight loss of 50 percent per dollar of tax revenue raised yields an implied deadweight loss from the individual income tax of 4.4 percent of GDP ($0.5 \times 8.4 = 4.2$). Chris Conover finds an average marginal excess burden of 52 cents for every dollar of federal income tax raised. The Congressional Budget Office found that “typical estimates of the economic cost of a dollar of tax revenue range from 20 cents to 60 cents over and above the revenue raised.” See Edgar K. Browning, *Stealing from Each Other: How the Welfare State Robs Americans of Money and Spirit* (Praeger Publishers, 2008), p. 156; Christopher J. Conover, “Congress Should Account for the Excess Burden of Taxation,” Cato Institute Policy Analysis no. 669, October 13, 2010; and “Budget Options,” Congressional Budget Office, February 2001, p. 381.



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