

# California Employer Guide to Federal “No Tax on Overtime” Law: Key Takeaways That May Surprise and Challenge Your Workplace

Insights

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California employers might be surprised by some important nuances in the “No Tax on Overtime” rules that rolled out nationwide last year and may create especially challenging obligations for employers in the Golden State. The new federal tax rules are not only surrounded by misconceptions but also inherently more complicated when overtime is paid in a state like California that has OT requirements that go beyond what’s federally required. We’ll break it all down and give you the top employer takeaways.

## Quick Overview

The One Big Beautiful Bill Act (OBBBA), which President Trump signed into law last year, includes a new federal income tax deduction related to overtime pay. This new rule (which applies for tax years 2025 through 2028):

- **allows an eligible worker to take a deduction on their individual tax return** of up to \$12,500 (or \$25,000 if married filing jointly) in “qualified overtime compensation” they received during the applicable tax year; and
- **imposes new filing and information reporting requirements on employers** related to such qualified overtime compensation (the IRS granted employers penalty relief for failures to comply with these new requirements, but the relief applies only for taxable year 2025).

Under the OBBBA, “**qualified overtime compensation**” means overtime compensation (excluding qualified tips) paid to an individual that:

- **is required by federal law** – specifically, under section 7 of the Fair Labor Standards Act (FLSA); and
- **exceeds the individual’s “regular rate”** as determined by the FLSA.

For various reasons, the “No Tax on Overtime” title of these new provisions is a misnomer, as we covered for employers nationwide in our prior Insight: [Separating Myth From Reality on New “No Tax on Overtime” Law: Key Facts Employers Must Know This Tax Season and Beyond](#).

This Insight will focus on one of the key nuances that will be especially challenging for California employers: **Overtime pay that is required by state – but not federal – law is not “qualified overtime compensation” under the OBBBA.**

## How “No Tax on Overtime” Gets Extra Complicated for California Employers

While the FLSA sets the national minimum overtime standard, states are free to enact more protective overtime rules – and California has one of the most expansive standards in the country, with five potential overtime triggers that appear to overlap but have precise rules for application. Here’s a snapshot comparison of the FLSA and California’s Labor Code:

- **FLSA.** The federal law generally has only one overtime trigger that requires employers to pay covered, nonexempt employees at least 1.5 times their regular rate of pay for all hours worked beyond 40 hours in a workweek.
- **California’s Labor Code.** The state’s overtime rules generally require employers to pay covered, nonexempt employees overtime premium pay when employees work more than certain daily or weekly thresholds, or when they work all seven days in the workweek (but these rules cannot be stacked – meaning each paid hour may only receive one overtime premium). Specifically, employers must pay:
  - 1.5 times the employee’s regular rate of pay (unless double time is required, as explained below) for (1) all hours worked beyond eight hours in a workday, (2) all hours worked beyond 40 hours in a workweek, and (3) the first eight hours worked on an employee’s seventh consecutive day of work in the workweek.
  - Twice the employee’s regular rate of pay (“double time”) is required when an employee works (1) more than 12 hours in a workday or (2) more than eight hours on an employee’s seventh consecutive day of work in the workweek.

### Employer Takeaway:

- **Overtime pay that is required by California law, but not required by the FLSA, even hours worked over 40, is not “qualified overtime compensation” for purposes of the new federal tax rules, and employers should not report it as such.**
- When some, but not all, of OT paid in a pay period is required by the FLSA, employers will need to parse out the federally required portion when reporting the individual’s qualified overtime compensation. **Properly tracking, calculating, and reporting these amounts may be challenging and burdensome for employers.** In addition, employees who expected a greater tax benefit may be unpleasantly surprised to find out that only a small portion of their overtime pay (or, potentially, none of it) is tax deductible.

And it gets more complicated. While both the FLSA and California's overtime provisions exempt certain employees from coverage, California's exemptions are much narrower and more protective of employees. This means that California requires payment of overtime when the FLSA will not "require" it. For example:

- **Stricter Tests.** Both the FLSA and California law include an exemption category for certain executive, administrative, and professional employees. Employees may qualify for these salaried exemptions under the FLSA but not under the state law because California applies a higher salary threshold and a more stringent duties test. On a more fundamental level, some employees whose duties could qualify for a salaried exemption under the FLSA or California law may not be receiving any salary, thereby defeating a salaried exemption. For other exemption categories, California also applies stricter tests compared to the FLSA, such as the exemptions for outside salespeople and computer employees.
- **Litigation Presumption of Non-Exempt Status.** Under both federal and state law, all employees are presumed to be non-exempt. An employer thus has the burden of proving that an exemption applies, but without further guidance from the IRS and courts, it remains to be seen how this impacts an employer's good faith determination that FLSA overtime is "required" or "not required" as to particular exemptions. In other contexts, an employer's good faith determination to comply with the law has some sway. It may well be that an employer's objective good faith determination that FLSA overtime is "required" or "not required" under the circumstances unique to each case will not be impacted by the presumption used for evidentiary purposes in litigation.

**Employer Takeaway:** The fact that an employee may qualify as exempt under federal, but not state, overtime rules creates a legal gray area for purposes of the new federal tax rules related to qualified overtime compensation. Based on the provisions added to the Internal Revenue Code, as well as IRS guidance on this issue so far, overtime compensation is likely not "qualified overtime compensation" if it is paid to an employee who would – or could be – FLSA-exempt but is treated by the employer as nonexempt due to state law requirements or other reasons. Practically speaking, the IRS might not actually audit for this – however, we recommend that employers be cautious in these scenarios until the agency issues regulations that explicitly address these issues. You should stay tuned for any IRS updates and work with counsel if you are unsure whether overtime pay is "qualified" for purposes of your new filing and reporting obligations.

- **Some FLSA Exemptions Not Available in CA.** California does not recognize some of the overtime exemptions that are available under federal law. For example, the state does not recognize an exemption unique to "highly compensated employees" – nor does it recognize some of the federal exemptions specific to auto dealerships. As another example, while the FLSA broadly

exempts agricultural employees, California now imposes overtime requirements for ag workers.

**Employer Takeaway:** Same as above – if an employee qualifies for an exemption for FLSA purposes but fails to meet the criteria for any of the California's available exemption categories, compliance becomes murky. We think this is especially true in scenarios where the available federal exemption is not recognized at all by the state. **Until the IRS issues more guidance on this issue, proceed with caution and work with counsel to determine the best approach.**

## Conclusion

All employers should work with counsel on filing, reporting, and withholding issues, as well as employee communications, related to qualified overtime compensation. This is especially true for employers operating in California or that have CA-based employees since these new employer obligations may be significantly more complicated in the state due to its unique overtime framework.

We will continue to monitor this and all areas of labor and employment law. We expect the IRS to release more guidance in the near future, so make sure you are subscribed to our Fisher Phillips' Insight System to get the most up-to-date information. If you have questions, contact your Fisher Phillips attorney, the authors of this Insight, any member of our Wage and Hour Team, or any attorney in our California offices.

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