No Tax on Tips or Overtime Pay- A Marriage Penalty or Bonus?

Quick-Take: The new deductions for tips and overtime compensation seem to be closely aligned, but with an important difference which makes one begin to wonder if Congress made a mistake but, in its rush, to enact the tax bill by July 4 to accommodate President Trump's self-imposed deadline, the mistake was never caught.

Background: The One Big Beautiful Bill Act (OBBBA-beauty being in the eye of the beholder) provides for two new deductions for income derived from tips and overtime compensation.

Tip Income: OBBBA adds a new section to the Tax Code, IRC 224, which allows a deduction for *qualified tip* income. But as with many other new deductions under OBBBA, the claimed 'no-tax-on-tips' comes with a phaseout. That phaseout starts at $150,000 of modified adjusted gross income (MAGI), and $300,000 in the case of married joint returns. The phaseout rate is $100 per $1,000 of MAGI. The 'modifications' that are added are for income excluded because it was earned by working abroad, e.g.. Puerto Rico. This tip income tax deduction is not an itemized deduction, which means that the tip earner will be able to claim the standard deduction on top of this tip income tax deduction. If the tip earner is married, he/she *must* file a joint income tax return to claim the tip deduction.

Overtime Compensation: OBBBA adds a new Tax Code section, IRC 225, which provides a deduction for *qualified overtime compensation*. This deduction is $12,500 or $25,000 in the case of a joint tax return. Again, there is a phaseout provision, the same phaseout as it is for the tip income tax deduction. Similarly, as with the tip income tax deduction, married individuals *must* file jointly to claim the overtime compensation deduction.

There is no explanation from Congress why the tip income tax deduction limit is $25,000 while the overtime compensation tax deduction limit is either $12,500 or $25,000 depending on whether the overtime compensation is reported on a joint tax return.

Marriage Penalty? Consider the following, albeit somewhat silly, examples.

Example: A group of friends in their 20's gathers to discuss the impact of OBBBA. Two couples are not married but they are each thinking about it. Abby and Ben are servers in an expensive restaurant. Most of their earnings come from tips. Cara and Don are licensed electricians, both of whom work a lot of overtime, well above the average. The last friend is Evan, who works as an accountant.

Abby and Ben wonder how much the 'no-tax-on-tips' rumor that they heard is going to save them. Cara and Don are interested in the effect of 'no-tax-on-overtime-compensation' rumor that they heard will save them in taxes. The answer could impact their decisions to marry. Their friend, Evan, as a CPA, is stuck having to explain to his friends the impact of how the 'no-tax' provisions in the House version of the OBBBA ultimately were converted to a deduction in the Senate's version of the bill, along with some phaseout rules.

Abby and Ben will *each* get a $25,000 deduction if they are not married. Cara and Don will *each* get a $12,500 deduction if they remain as single taxpayers. In the aggregate, these 4 friends will receive $75,000 in the new OBBBA deductions.

But if Abby and Ben get married, their OBBBA deduction drops to $25,000. If Cara and Don get married, they can deduct $25,000 on their joint return. Consequently, if both couples marry, their aggregate OBBBA deductions drop to $50,000, leading to what one might call a **marriage penalty.**

Okay, now to get a bit sillier. What if Abby instead marries Don, and Ben instead marries Cara? [Hey, it could really happen- they're young!] Now each married couple receives $50,000 in OBBBA deductions, or a total of $100,000 in OBBBA deductions among all four of them, leading to what one might call a **marriage bonus.**

Conclusion: The difference in the OBBBA limit on tips and overtime compensation for single individuals, but not married individuals, may be unintentional, considering the fact the phase-in limit language is identical for these two OBBBA deductions. The House version of the OBBBA bill did not include any limit at all, so that language was added (someone has reported, in secret) in the Senate's version of the bill. Was this difference intended by the Senate, or the House, or anybody who took the time to read the bill before voting on it? This **marriage penalty -or- marriage bonus** interpretation is probably just a small glitch that can be clarified in the Proposed Regulations. Yet it still leaves you wondering what other 'glitches' are buried in the OBBBA that was rushed into law to beat a July 4th deadline.

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