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From Paychecks to Perks

Navigating New OBBBA Rules on Compensation & Benefits

Executive Compensation and Key Payroll Developments

AUG 12, 2025

2025

FEDERAL TAX LAW CHANGES

The One Big Beautiful Bill Act enacted significant tax changes affecting employee compensation and benefits starting in 2025.

Topics Covered – Payroll

- “No Tax” On Overtime
- Misc. Changes Affecting Employees’ Net Pay After Taxes
- Form 1099 Reporting Threshold
- Qualified Bicycle Commuting Reimbursements
- Moving Expense Reimbursements
- Educational Assistance Programs
- Paid Family and Medical Leave Credit

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FEDERAL TAX LAW CHANGES

The One Big Beautiful Bill Act enacted significant tax changes affecting employee compensation and benefits starting in 2025.

Topics Covered – Executive Comp.

- $1 Million Limit on Compensation Deductions
- Excise Tax on Excess Compensation for Tax-Exempt Organizations
- Impact of Alternative Minimum Tax (AMT) Changes on Incentive Stock Options (ISOs)
- Qualified Small Business Stock (QSBS)

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Key Payroll Developments

"No Tax" On Overtime

No Tax on Overtime: Prior Law

Fully Taxable	W-2 Reporting
Overtime pay is **fully taxable** and subject to same employer tax reporting and withholding obligations as other wages.	Overtime reported on W-2, but **not separately identified**.

No Tax on Overtime: New Law

Effective Date: Applies to compensation paid from **January 1, 2025, through December 31, 2028.**

FLSA Premium Pay

- Creates new tax rules for "**FLSA premium pay**"—i.e., the portion of overtime compensation *above the regular rate* that is required by the Fair Labor Standards Act.
- The FLSA mandates overtime be paid at **150% of the regular rate**; the **extra 50% above the regular rate is the FLSA premium amount.**

Employer Tax Withholding & W-2 Reporting

Overtime pay remains subject to standard tax withholdings for wages. However:

- Employers must separately report FLSA premium pay on employees' Form W-2 (likely in a new field).
- Employers that have not tracked FLSA premium pay in 2025 may reasonably "**approximate**" the amount. IRS guidance is expected on what qualifies as reasonable.
- The IRS may issue a new tax-withholding formula specific to FLSA premium pay (likely effective for 2026); until then, the regular tax withholding rates apply.

Employee Tax Deduction

When filing their personal income tax returns, employees may claim a deduction for FLSA premium pay:

- **Up to $12,500** (single filers) or **$25,000** (joint filers).
- Deduction is above-the-line.
- However, deduction is phased out by $100 for each $1,000 of adjusted gross income above **$150,000** (single filers) or **$300,000** (joint filers). E.g., if AGI of single filer is $160,000, deduction reduced to $11,500.

Example 1

If an employee earns **$20/hour** and works **45 hours** in a week, the FLSA requires the 5 overtime hours to be paid at **$30/hour** (1.5× regular rate), resulting in total pay of **$150 for the 5 hours—$100 regular pay + $50 FLSA premium** pay.

Result: $50 must be separately reported on Form W-2 as FLSA premium pay.

Example 2

Same facts as Example 1, except CA law requires the employer to pay **$35/hour for overtime**, resulting in total pay of **$175 for the 5 overtime hours—$100 regular pay + $50 FLSA premium pay + $25 CA premium pay.**

Result: $50 must be separately reported on Form W-2 as FLSA premium pay. The extra $25 of overtime pay (beyond the FLSA-required $50) is not separately reportable on Form W-2.

Example 3

Same facts as Example 1. Also assume that the employee requests that the **employer withhold no taxes from the $50 of FLSA premium pay**.

Result: The employer cannot honor the request. It must withhold taxes according to either (i) the employee's Forms W-4 and DE 4 withholding elections, or (ii) federal and CA supplemental tax withholding rates. (Overtime is "supplemental wages" for tax withholding purposes.)

The IRS is expected to issue guidance updating the tax withholding tables to reflect the no tax on overtime rule. Until then, the employee may adjust the amount withheld by updating his or her W-4 and DE 4.

Example 4

In 2026, an employee receives a Form W-2 reflecting **$15,000 of FLSA premium pay** for 2025. When filing her 2025 federal tax return, the employee uses the standard deduction rather than itemized deductions. The employee is a **single filer**, and her **2025 AGI is less than $150,000**. May the employee deduct the $15,000 from her taxable income for 2025?

Result: Yes. The deduction is available above-the-line. Whether the employee uses the standard deduction or itemized deductions is irrelevant.

Example 5

Under its compensation policies, a governmental **employer pays overtime to exempt employees based on the FLSA rate** (1.5x regular rate). In 2025, an exempt employee who earns **$20/hour works 45 hours in a week**. The employee receives **total pay of $150 for the 5 hours—$100 regular pay + $50 premium based on FLSA rate**.

Result: Because the $50 premium is not required by the FLSA, it is not separately reportable on Form W-2. Additionally, the employee is not entitled to a tax deduction for any part of the overtime pay.

Example 6

Same facts as Example 1, in which the employee received $50 of FLSA premium pay in 2025. The employee's 2025 effective tax rate for federal purposes is 20%.

Result: The new overtime rule results in $10 of federal tax savings to the employee. (Unclear as of now whether CA and other state tax laws will conform to this BBB provision.).

No Tax on Overtime: Next Steps

Effective Date: Applies to wage payments made on or after **January 1, 2025, through December 31, 2028.**

- Review and **confirm which overtime pay qualifies as FLSA premium pay.** Employers that pay overtime at higher rates (e.g., double time or other contractual premiums) must ensure that only the FLSA-mandated portion (i.e., 50% above the regular rate) is reported as FLSA premium pay.
- **Monitor IRS guidance for updated reporting fields** and any new withholding instructions specific to overtime pay.
- Ensure **payroll systems can isolate FLSA premium pay** and **report it separately on Form W-2.**
- **Be prepared to field questions from employees about the new rule.** Consider informing employees that while overtime remains subject to withholding, they may be eligible to deduct that pay on their federal tax returns, **but only the FLSA-mandated portion.**
- If unable to track FLSA overtime paid in 2025, **monitor IRS guidance on acceptable methods** for reasonably approximating the FLSA premium amount.
- Recognize that this deduction may increase some overtime-earning employees' net tax benefit at year-end, making overtime shifts more financially appealing. This may have workforce planning, scheduling and retention implications. Consider effects on employer's overtime policies.

Miscellaneous Changes Affecting Employees' Net Pay After Taxes

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Tax Change	2025 Amount	Filing Status	AGI Phaseout	Benefit Type
Increased Standard Deduction	$31,500/$23,625/$15,750	Joint/HOH/Single	None	Income Reduction
Increased Child Tax Credit	$2,200	All eligible	Varies	Direct Credit
Increased SALT Deduction	$40,000	All	None	Itemized Deduction
Increased AMT Exemption	$1,000,000/$500,000	Joint/Single	None	Exemption
New Deduction for Certain Car Loan Interest	Up to $10,000	All	$200K/$100K	Above-line Deduction

Form 1099 Reporting Threshold

Form 1099 Reporting Threshold: Prior Law

Report Payments

Taxpayers are generally required to issue Form 1099-NEC or 1099-MISC to **report payments of $600 or more** in a calendar year for goods and services provided by non-employees.

Threshold

$600 threshold had been in place for decades, with no inflation adjustments.

Form 1099 Reporting Threshold: New Law

Increased Threshold

Beginning with payments made in 2026, the **annual reporting threshold increases to $2,000** per recipient. (The $600 threshold still applies to payments made in 2025.)

Inflation Adjustment

The **$2,000 threshold will be adjusted for inflation** in subsequent years.

Form 1099 Reporting Threshold: Next Steps

Effective Date: Applies to reportable payments made on or after **January 1, 2026**.

- Update AP and **accounting systems to reflect the new $2,000 threshold,** starting with reporting season for payments made in 2026.

- Ensure **continued compliance with $600 threshold** for payments through **December 31, 2025**.

Qualified Bicycle Commuting Reimbursements

Qualified Bicycle Commuting Reimbursements: Prior Law

Reimbursements

Employers **could reimburse employees up to $20 per month** ($240 per year) for bicycle-related commuting expenses on a tax-free basis under section 132(f) of the Internal Revenue Code.

Previously Suspended

This exclusion was **suspended from 2018 through 2025** but **was scheduled to resume in 2026**.

Qualified Bicycle Commuting Reimbursements: New Law

Permanently Repealed

The BBB **permanently repeals the federal exclusion** for qualified bicycle commuting reimbursements under section 132(f).

Non-deductible

Consequently, bicycle commuting reimbursements constitute taxable wages for federal tax purposes and are **non-deductible by the employer**.

Qualified Bicycle Commuting Reimbursements: Next Steps

Effective Date: Immediate

- Continue **treating all bicycle reimbursements as taxable and non-deductible** for federal tax purposes.
- Review employee benefit policies to **ensure they reflect federal law**.
- Evaluate **state-level tax treatment** of the reimbursements. **California may continue to treat bicycle reimbursements as excludable and deductible**.

Moving Expense Reimbursements

Moving Expense Reimbursements: Prior Law

Reimbursements

Employers could **reimburse employees for qualified moving expenses on a tax-free basis** under section 132(g) of the Internal Revenue Code.

Previously Suspended

This exclusion was **suspended for most employees from 2018 through 2025** but **was scheduled to resume in 2026**.

Moving Expense Reimbursements: New Law

Permanently Repealed

The BBB **permanently repeals the exclusion for qualified moving expense reimbursements** under section 132(g), except for active-duty military.

Taxable

Consequently, **reimbursements for moving expenses constitute taxable wages** for federal tax purposes.

Moving Expense Reimbursements: Next Steps

Effective Date: Immediate.

Continue **treating all moving-expense reimbursements as taxable wages** for federal tax purposes.

Review relocation assistance policies to ensure they reflect federal law.

Evaluate **state-level tax treatment** of the reimbursements. **California may continue to treat moving-expense reimbursements as excludable**.

Qualified Educational Assistance Programs

Qualified Educational Assistance Programs: Prior Law

Educational Assistance Program Limits

"Educational assistance" provided under an employer's qualified educational assistance program (which includes eligible student loan repayments) in an amount up to **$5,250** per year is excluded from the employee's gross income. Limit has been capped at **$5,250** since 1986.

Loan Reimbursements

Employers can use educational assistance programs to help employees pay student loans through **December 31, 2025** (i.e., employers could reimburse employee student loans through qualified educational assistance program).

Qualified Educational Assistance Programs: New Law

Educational Assistance Program Limits Increased

The $5,250 cap on the exclusion from the employee's gross income will be **adjusted for inflation on an annual basis** for tax years beginning after 2026.

Loan Reimbursements Made Permanent

The OBBBA makes the **student loan repayment provisions** available under qualified educational assistance programs **permanent**.

Qualified Educational Assistance Programs: Next Steps

Effective Date: Various.

Review educational assistance plans to assess if language on reimbursement limits allows for inflation adjustment or would need to be amended to accommodate the adjustment (if desired).

Review education assistance plan provisions relating to loan reimbursements (if any) to assess if language allows for continued reimbursement of loans after December 31, 2025 (if desired).

Paid Family and Medical Leave Credit

The information contained in this presentation is provided for general informational purposes only and does not constitute legal advice.

Paid Family and Medical Leave Credit: Prior Law

Credits

Employers who provide paid family and medical leave can claim a tax credit equal to a percentage of wages they pay to qualifying employees while they are on family and medical leave.

The credit is worth 12.5% and goes up by 0.25% for each percentage of wages paid over 50% up to a maximum potential 25% credit.

Scheduled to Sunset

The credit is available for wages paid in taxable years beginning after December 31, 2017 and before **January 1, 2026**.

Paid Family and Medical Leave Credit: New Law

Credits Made Permanent

OBBBA makes the paid family and medical leave credit **permanent**.

Expanded Scope for Credits

Scope of the credit expanded to: (1) cover employer-paid insurance premiums (in addition to wages), (2) reduce the employer work requirement from one year to 6 months, and (3) allow employers to count state and local mandated paid leave toward eligibility for the tax credit (but the credit is only available for wages paid above mandated amounts).

Paid Family and Medical Leave Credit: Next Steps

Effective Date: January 1, 2026.

- Employers who already provide paid family and medical leave and take advantage of the credit can continue to do so in 2026 and beyond. Employers should review existing policies and make adjustments, as appropriate, to **take advantage of the credit expansions** under the law (e.g., for payments for insurance premiums).
- Employers who do not currently offer paid family and medical leave may wish to consider offering paid leave not that the tax credit has become permanent.

Executive Compensation Developments

$1 Million Limit on Compensation Deductions: Code Section 162(m)

$1 Million Limit on Compensation Deductions: Background

Section 162(m) Generally

- Applies to publicly held corporations.
- Limits tax deduction for compensation paid to "**covered employees**" to $1 million.
- Pre TCJA, covered employee = CEO and the three highest-paid officers (excluding the CFO) as of the last day of the year.
- Pre TCJA, companies could deduct compensation exceeding $1 million if it was considered "qualified performance-based compensation."
- **Section 1504 affiliated group aggregation rules apply.**

Tax Cuts and Jobs Act of 2017 (TJCA)

- Removed exception for qualified performance-based compensation.
- "Covered employee" definition broadened to include:
  - CEO and CFO at any time during the taxable year.
  - Three highest-paid officers (excluding the CEO and CFO) for the taxable year.
  - <u>Anyone</u> who was a covered employee beginning after December 31, 2016 —"once covered, always covered" rule.
- Clarified that limitations apply to affiliated groups with at least one publicly held corporation.

American Rescue Plan Act of 2021 (ARPA)

- Further expands covered employee definition to include the next five highest-paid employees, even if not officers.
- "ARPA Five" determined annually, and are not covered by the "once covered, always covered" rule.
- Definition of employee broadened to include employees of any member of the company's affiliated group, and individuals performing substantially all of their services for the public company (even if employed by an unrelated entity).

$1 Million Limit on Compensation Deductions: New Law

Controlled Group vs. Affiliated Group

- All members of a controlled group and affiliated service group are considered to be publicly held if any member of the controlled group is publicly held.
- A "controlled group" means a group of entities that would be treated as a single employer under Code Section 414.
- This is the same controlled group determination that applies to retirement plans **and is significantly broader than under Section 1504**.

Pro-Rata Allocation of Deduction Limit

The $1 million deductible compensation limit is allocated to each member of the controlled group or affiliated service group based on the pro-rata portion of the total compensation paid by that member to the covered employee.

Example

Assume a three-member controlled group, with each paying a covered employee the following compensation in a calendar year:

Parent company of the controlled group, a publicly held corporation (P Corp): $1,500,000 paid to the covered employee

Subsidiary A (Sub A): $500,000 paid to the covered employee

Subsidiary B (Sub B): $250,000 paid to the covered employee

Total Compensation: $2,250,000

Step 1: Determine each entity's share of the total compensation:

- P Corp: $1,500,000 / $2,250,000 = 0.67 (approximately)
- Sub A: $500,000 / $2,250,000 = 0.22 (approximately)
- Sub B: $250,000 / $2,250,000 = 0.11 (approximately)

Step 2: Multiply each share by the $1 million deduction limit:

- P Corp's allowable deduction: $1,000,000 * 0.67 = $670,000
- Sub A's allowable deduction: $1,000,000 * 0.22 = $220,000
- Sub B's allowable deduction: $1,000,000 * 0.11 = $110,000

$1 Million Limit on Compensation Deductions: Next Steps

Effective Date: Applies to taxable years beginning on or after **January 1, 2026**.

- Determine which entities will be part of the controlled group and identify covered employees.
- Ensure payroll and accounting systems capture compensation paid by each member of the controlled group so the pro-rated allocable limitation amount can be calculated accurately.
- Implement procedures to pro-rate the $1 million cap among members of the controlled group in proportion to the amount of compensation paid to the covered employee by the controlled group member.
- Coordinate with the upcoming American Rescue Plan Act (ARPA) amendments to Section 162(m), which also become effective for tax years after December 31, 2026.

Excess Compensation for Tax-Exempt Organizations: Code Section 4960

Excess Compensation for Tax-Exempt Organizations

Effective Date: Applies to taxable years beginning on or after **January 1, 2026**.

Excise Tax

- Applies to covered employees of tax-exempt organizations.
- Imposes a 21% excise tax on:
  - Compensation exceeding $1 million in taxable year, plus
  - any "excess parachute payments" (e.g., severance).

Covered Employees

- Limited to five highest paid employees of the tax-exempt organization for a given year.
- Only applies to **current employees**.
- Status is cumulative—"once covered, always covered" rule.

Covered Employees (New Law)

- Now includes **any current or former employee** of a tax-exempt organization.
- **Applies regardless of title or position**, not limited to senior leadership.

Implications:

✓ **More individuals may trigger the excise tax** (e.g., non-executive professionals with high comp).

✓ **Deferred compensation, severance and vesting events** can unexpectedly cause excess pay.

Impact of Alternative Minimum Tax (AMT) Changes on Incentive Stock Options (ISOs)

AMT Impact on ISOs: Prior Law

AMT and ISOs

Incentive stock options (ISOs) are a type of tax-qualified equity award commonly issued by startup companies.

When an employee exercises an ISO, there is no direct reporting for ordinary income tax purposes, but the value of the stock above the exercise price (the "spread") is an adjustment for AMT purposes for the year of exercise.

AMT Income (AMTI) Exemption Amounts

Under the Tax Cuts and Jobs Act (TCJA), AMT income (AMTI) exemption amounts were increased significantly:

- $137,000 for joint filers
- $88,100 for single filers

(Above represents 2025 inflation-adjusted amounts.)

Exemption Phase-Outs

Exemption phase-out thresholds were also increased:

- $1,252,700 for joint filers
- $626,350 for single filers

The phase-out calculation applies to every $0.25 for each $1.00 over the threshold.

(Above represents 2025 inflation-adjusted amounts.)

Amendments to AMT from TCJA were scheduled to sunset as of December 31, 2025.

AMT Impact on ISOs: New Law and Takeaways

Effective Date: Applies to taxable years beginning on or after **January 1, 2026**.

Reduced Exemption Phase-Outs

The OBBBA **continues the higher AMTI exemption limits** but also **accelerates** the phase-out for high-income earners as follows:

- The AMTI exemption phase-out starting point is reduced to $1,000,000 (joint filers) and $500,000 (single filers).
- The phase-out calculation rises to **$0.50** (from $0.25) for every $1.00 of AMTI over the thresholds, meaning faster erosion of the exemption.

✓ Employees with higher incomes and/or significant built-in "spread" value may want to consider exercising ISOs in 2025 to reduce AMT liability.

✓ AMT is more likely to be triggered on an ISO exercise for employees residing in states with higher state/local income taxes (e.g., California, New York), because "SALT" tax deductions taken for regular income tax purposes are disallowed under the AMT rules.

Qualified Small Business Stock (QSBS)

Qualified Small Business Stock (QSBS)

Prior Law

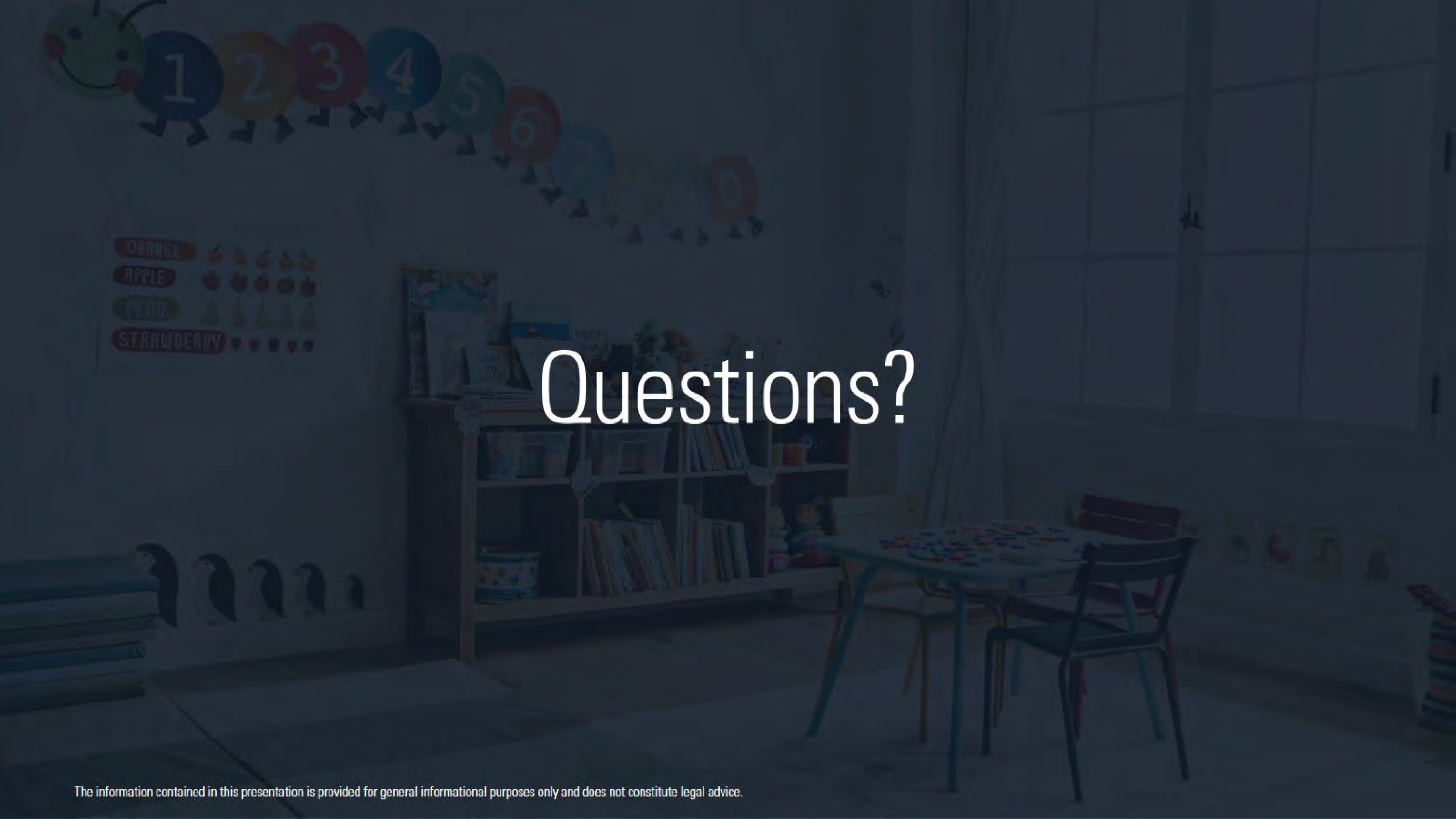
Code Section 1202 allows for the exclusion of a portion or even all of the capital gains on the sale of QSBS from federal income tax when certain conditions are met.

- **Gross assets limit**: $50 million.
- **Gain exclusion based on holding period**: 100% for stock acquired <u>and held for at least five years</u>.
- **Cap on gain exclusion**: Greater of $10 million ($5 million for married taxpayers filing separately) or 10x taxpayer's tax basis in the QSBS.

New Law

OBBBA amendments to QSBS rules increase the benefits related to QSBS to spur further investment into startups by investors and greater tax benefits for founders and early employees.

- **Gross assets limit**: $75 million (adjusted for inflation beginning in 2027).
- **Tiered gain exclusion based on holding period:**
  - 50% for stock held for at least 3 years;
  - 75% for stock held for at least 4 years; and
  - 100% for stock held for 5 years or more.
- **Cap on gain exclusion**: Greater of $15 million ($7.5 million for married taxpayers filing separately), adjusted for inflation beginning in 2027, or 10x taxpayer's tax basis in the QSBS.



Questions?

Presenters

Marcus Wu | Partner
San Diego
+1.858.509.4030
marcus.wu@pillsburylaw.com

Laura McDaniels | Partner
Silicon Valley
+1.650.233.4039
laura.mcdaniels@pillsburylaw.com

Amber Ward | Special Counsel
San Francisco
+1.415.983.1048
amber.ward@pillsburylaw.com