On-Demand Pay: Practices and Procedures

Overview —

On-demand pay, also called earned-wage access or instant pay, allows employees to use a mobile application to access some or all of their earned wages on a shorter pay cycle than the normal pay period for their employer. The programs are somewhat influenced by gig economy employers or platforms that offer services through mobile applications, but the programs also are offered through traditional employers.

The rise of on-demand payment programs can largely be attributed to the financial management incentives for employees and reducing turnover costs for employers. Early access to earned wages may help employees avoid overdraft and late fees, high-interest loans, and credit card bills. On-demand pay programs also may boost morale, increase financial wellness, help retain employees, and aid in recruiting talented workers.

On-demand payment technology also keeps pace with expectations in an increasingly digital marketplace where goods and services are able to be purchased using mobile devices and funds can be transferred instantaneously.

Benefits under the Covid-19 outbreak: Employees are facing a variety of stressful financial situations because of widespread layoffs and reductions in work hours caused by the pandemic. For those who remain in the workforce, on-demand pay access may provide faster access to funds for paying bills and buying emergency supplies. Access to paperless options allows employees to continue to pay expenses in the event that public health requirements cause banks to reduce or stop in-person operations, making funds inaccessible for employees who rely on paper check deposits.

Implementing an On-Demand Payment Program

Selecting a Vendor —

Little regulatory guidance exists that directly addresses the on-demand payment process. In the process of selecting a vendor, employers should try to determine the vendor's level of compliance aptitude, ensuring that the vendor can explain its position on the tax implications of its payment process.

Employers may avoid future legal difficulties by selecting a vendor that knows existing wage payment laws and actively tracks pending federal and state legislative and regulatory changes. The flexibility of the vendor's solution also may be crucial in the decision-making process, as future guidance could deem a current process to be noncompliant and require changes to the payment process.

Vendors should be asked about their ability to change to meet the standards of potential compliance rules. Laws and regulations that have implications for on-demand payments are discussed in the Compliance Considerations section.

Employers should consider the ease-of-use, privacy, and security of any computer software to be used by the payroll department and the mobile applications used by employees to initiate on-demand transactions. The employer's information technology department should be included in the decision-making process.

The employer also should note whether the vendor's software is able to take into account unique tax situations, such as garnishments and back taxes, when calculating net pay. The ability to include those situations ensures that, before an employee may access earned wages, enough of the employee's earnings would be available to pay the additional liabilities when the employer processes payroll.

The availability of different methods for employees to receive pay, such as Automated Clearing House payment processing to a financial institution or payroll card, and payment platforms such as PayPal and Venmo, also should be taken into account.

The employer's legal department should review the contract with the vendor, with particular attention paid to automatic renewals, exclusivity clauses, and whether changing a vendor affects the terms of the agreement.

Costs for Employees —

Fees for on-demand payments vary but may include a per-transaction fee or a flat monthly fee that allows for an unlimited or a capped number of transactions. Some vendors do not charge employees or request payments in the form of a suggested tip.

When setting up an on-demand pay program, employers may want to consider subsidizing the costs, or offering employees a free program or one with a nominal monthly charge, so that the transactions do not become a significant employee expense.

Establishing Policies and Parameters —

Some on-demand systems allow employers to limit the amount of pay to a percentage of the employee's net pay, to limit the number of withdrawals in a pay cycle, or to limit the number of consecutive pay periods for early access to earned wages. Placing restrictions may deter employees from becoming too dependent on instant-access options.

Employers may consider offering an on-demand payment system in combination with other finance-management benefits to provide employees with multiple financial wellness options. Such benefits may take the form of savings programs, budgeting tools, or low-cost loans repaid over the course of several months; some vendors offer these benefits in addition to an on-demand payment program.

On-Demand Payment Methods —

Employers seeking to establish an on-demand payment program must decide whether to implement an in-house system or contract with a third-party vendor. On-demand payment systems exist on a spectrum with varying levels of employer involvement, ranging from software that integrates into an existing payroll process to stand-alone technology that allows employees to request an advance. Different on-demand methodologies come with different areas of regulatory comfort or concerns.

The payment methods generally involve components of one of two workflows at the extremes of the spectrum:

In-house processing workflow: The on-demand payment process is managed and funded by the employer. An employee requests access to earned wages and the employer runs payroll in real time to calculate and pay the amount of available net compensation. The employee's paystub lists the on-demand payments as a deduction.

Third-party processing workflow: An employee requests access to earned wages and the payment is funded by a vendor. The amount of available net pay is calculated using wage and hour information provided by the employee or payroll data provided by the employer and takes into account any limits on the percentage of net pay that may be accessed.

The vendor then recovers the funds from the employee's bank account on payday or from the employer; some vendors offer both options. The employee's paystub is unaffected and reflects the total net pay for the pay period.

This workflow generally allows employers to continue to process payroll without changes to regular cycles.

Employers should ensure that employees are educated on the on-demand payment process and what employees can expect in terms of payday payments and any account debiting.

Compliance Considerations

Constructive Receipt —

Employees are considered to have constructive receipt of taxable income if it has been credited to their account, set apart for them or otherwise made available so that they may draw upon it at any time, provided that the employee's control of the income is not subject to substantial limitations or restrictions. On-demand payments may constitute constructive receipt of taxable income, triggering employer tax liabilities, reporting requirements, and possibly requirements to remit withheld taxes on an accelerated schedule.

There is little regulatory guidance that outlines constructive receipt principles in relation to on-demand payments. Vendors have taken different approaches to interpreting the constructive receipt concept in order to avoid compliance concerns for employers. Approaches generally are rooted in one of two interpretations: whether constructive receipt relies on the source of the funding or the timing of the funding.

Under the interpretation that constructive receipt may be avoided depending on the source of the funding of the on-demand payment, if the vendor is providing the advance, employers may be shielded from liability because the transaction is between an employee who has arranged the account and the vendor. Instead of a payment of taxable income, employees are redirecting scheduled direct deposits in an arrangement to secure loaned amounts.

Under the interpretation that constructive receipt depends on the timing of the funding regardless of the source, there may be a concern that constructive receipt occurs sooner than payday. The agreement is considered to exist between the vendor and the employer; if the employer hires the vendor for the purpose of providing on-demand payments on behalf of the employer, the amounts still may be considered taxable income at the time of the payment. However, as long as taxes are taken into consideration when calculating the payment, it is possible that reporting and remitting the withheld amounts as part of an employer's regular payment cycle would not cause a compliance concern.

Wage Deductions —

Nearly all the states have wage-payment laws or regulations that set minimum standards that employers must observe when paying workers. Similarly, federal and state laws and regulations establish limits on amounts that may be deducted from an employee's pay and protect a portion of an employee's pay from garnishments, support orders, or tax levies. Employers should communicate with vendors to ensure that the on-demand payment process does not risk violation of these laws.

Wage Assignments —

Wage assignments stem from a voluntary agreement between the employee and the creditor, and fall under the law of contracts. Some states outlaw wage assignments entirely; others prohibit assignment of future wages; and some states restrict the amount payable on future wages, but not that of earned wages. The vendor should be knowledgeable of whether its on-demand payment process may be a form of wage assignment and should not violate wage-assignment laws.

Loans —

A process that debits an employee's account or charges may indicate that a transaction is a loan under state and federal lending laws. Employers should check whether a vendor has researched possible money-transmitter licensing requirements and is properly licensed under those requirements.

Recordkeeping —

The Fair Labor Standards Act requires employers to record deductions from wages for each individual employee, including the types of items deducted, amounts debited, and the dates involved. On-demand payments deducted from wages as part of the payroll process should be accurately reflected on the employee's paystub.

Time-card approval is a possible area of concern because managers typically approve hours once per pay period. Vendors have various mechanisms to handle instances when hours are not approved before accessing early wage payments. Some vendors rely on scheduled hours within the employer's workforce-management system to give employees credit while others use customer service representatives to contact managers for time-and-attendance approval before pay can be accessed.

Compliance with state data-protection laws is necessary. Employers should determine how long records can be retained and have verification provided after data is destroyed. When the sharing of documents with vendors is required, employers should ensure that data privacy and security protocols are in place, especially with regard to earnings statements, Social Security numbers, and other personal information.

Upcoming Guidance —

In March 2019, a spokesman for the Internal Revenue Service said that the agency sought to provide guidelines that would help employers determine whether a payment constitutes wages or a loan and clarify the tax treatment for each type of payment. Among the factors that need to be taken into account are how frequently payroll operations usually run and the role that a bank plays in the employer's payroll process, the spokesman said.

Updated guidance may be issued in the form of regulations or a set of frequently asked questions and answers, though a date for the release of such guidance is not set. The guidance may address the conditions that may trigger actual or constructive payment of wages and whether withholding, depositing, and reporting of taxes associated with on-demand pay may be processed on the employee's next regular payday.

Editor's note: Additional research for this payroll chapter on the practices and procedures of on-demand pay was gathered through interviews with Gerard Griffin, chief executive officer, QRails Inc.; Sarah Grotta, director of Debit and Alternative Products Advisory Service, Mercator Advisory Group; Carl Morris, vice president of compliance, FlexWage Solutions; Lauren Saunders, associate director, National Consumer Law Center; and Chris Suppa, senior vice president of business development, FlexWage Solutions.

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