What's the deal with on-demand pay?

There were at least 11 on-demand pay vendors at the American Payroll Association's Annual Congress last month, not including the national third-party payroll providers. Nothing wrong with vendors highlighting their products at a convention of Payroll professionals. But if you only listened to the hype, you'd think on-demand pay was the next best thing since sliced bread. We got a very different impression from talking with our tablemates at lunch one day during the Congress—no one wanted to deal with it.

On-demand pay is marketed to employees who live paycheck-to-paycheck and run out of money before the next payday, which has given rise to the usurious payday loan industry. It's also marketed to millennials, who grew up expecting everything on demand. It's supposed to fill the void and get rid of payday lending by allowing employees to access some of their earned wages before payday.

The perceived flaw: Unless on-demand pay is capped at a low amount, employees may have the same problem they have with payday lenders—a constant need to tap their pay early to make up for their shortened paychecks. And capping at a low amount would seem to defeat the purpose of on-demand pay. These were real concerns for our tablemates. On-demand pay is likely coming for you. How should you evaluate on-demand pay vendors?

Unfortunately, you're operating in a regulatory void.

What regulating agencies say

The only federal agency to address on-demand pay is the Consumer Financial Protection Bureau. It issued two documents at the end of 2020, both of which concluded that on-demand pay wasn't an extension of credit under Regulation Z, which is the truth-in-lending regulation (the Federal Reserve names its regulations with letters):

- An advisory opinion published in the *Federal Register* outlining the characteristics an on-demand pay product needs to have to ensure it's not extending credit under Reg. Z: The vendor contracts with employees; employees can't access more than their earned pay; employees pay only a nominal fee for the service; employers make payroll deductions and remit the amount to the vendor; the vendor can't sue employees who default; and the vendor doesn't run credit checks on employees.
- An approval order for an on-demand pay vendor meeting the advisory opinion's criteria.

The IRS hasn't yet provided any guidance on the stickiest issue for Payroll—whether employees who can access some of their wages on demand are in constructive receipt of all of their wages, thus triggering your obligation to withhold. However, a proposal in the administration's 2023 budget does cover on-demand pay. According to the proposal, employees who can access their pay on demand may be in constant constructive receipt, and, therefore, taxable, on their wages as they are earned.

The proposal would require employers offering on-demand pay arrangements to maintain either a daily or a miscellaneous payroll period and to withhold and pay payroll taxes on employees' earned wages on a daily basis. These conditions would probably dampen employers' enthusiasm for offering an on-demand pay benefit.

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Even if these provisions don't survive the budget process, it gives the IRS a pathway to issue guidance.

5 questions to ask vendors

Before you signal your approval of C-suite plans to roll out an on-demand pay benefit, make sure they are very sure of what they're signing on to. They (or you) should demand answers to these questions:

1. **How is the program structured?** You want to know whether the vendor controls employees' direct deposit accounts or alternatively how the program integrates with employees' direct deposit or paycard accounts, what the nominal fee is and who sets the cap on the amount employees can access.
2. **What is the additional burden on the Payroll department?** You should be crystal clear with the C-suite regarding the extra work—daily reports of hours worked to the vendor, remittances to the vendor—and the extra expense this will entail.
3. **How does on-demand pay affect withholding?** You need to ensure employees' taxes are withheld and that there's enough left over so you can withhold their benefit contributions and honor garnishments.
4. **What impact does on-demand pay have on state payday law compliance?** State payday laws run the gamut, from specifying the deductions you may make from employees' pay to the information you must include on their pay statements. Some states prohibit employees from voluntarily assigning their wages to a third party.
5. **What about data privacy and security?** You protect employees' names, Social Security numbers and financial information. You need to ensure the vendor does, too.

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