

CLARIFY TAX TREATMENT OF ON-DEMAND PAY ARRANGEMENTS

Current Law

For purposes of employment taxes (social security and Medicare taxes, unemployment tax, and income tax withholding), wages are defined in the Internal Revenue Code (Code) as all remuneration for services performed by an employee for their employer, including the cash value of all remuneration paid in any medium other than cash. Employers withhold and pay employment taxes based on payroll periods. A payroll period is defined for employment tax purposes as a period for which a payment of wages is ordinarily made to the employee by the employer, and a miscellaneous payroll period is defined as a payroll period other than a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, or annual payroll period.

Longstanding employment tax regulations provide that wages are considered paid when they are actually or constructively received by the employee. An employee is in constructive receipt of wages when an amount is set apart or otherwise made available so that the employee may draw upon that amount at any time. Furthermore, when an employee has unfettered control over the date on which they actually receive their wages, they are typically considered to be in constructive receipt of those wages.

Reasons for Change

Employers and third-party payors increasingly allow employees to receive payment of earned wages before their regularly scheduled pay dates (these arrangements are referred to here as “on-demand pay” arrangements; however, the arrangements are referred to in various ways by employers and third-party payors, including as “earned wage access programs”). On-demand pay arrangements vary significantly, but generally, employees use mobile applications to access accrued wages before the end of their regular pay cycle and the amounts are transferred (almost instantaneously) to a bank account, pre-paid debit card, or payroll card.

Employees with access to an on-demand pay arrangement may be in constant constructive receipt of their wages as they are earned. Employers that offer on-demand pay arrangements should maintain either a daily or a miscellaneous payroll period and should withhold and pay employment taxes on employees’ earned wages on a daily basis.

It is unlikely that many, if any, employers or third-party payors treat employees with access to on-demand pay arrangements as being in constructive receipt of their wages because it would be a significant financial and administrative burden on the employers or third-party payors to configure their payroll systems and make payroll deposits on a daily basis. To avoid treating employees as being in constant constructive receipt of their wages, some employers or third-party payors ignore the constructive receipt issue entirely or treat the arrangement as a loan from the employer to the employee. The result in either case is that wages are treated as paid on the regularly scheduled pay dates, rather than when the wages are constructively received by the employees.

Legislation addressing the tax treatment of on-demand pay would provide certainty and uniformity for taxpayers and would establish a uniform and administrable system for the IRS. Without legislation, on-demand pay arrangements will continue to proliferate with some taxpayers taking aggressive tax positions on the timing of the wage payment for employment tax purposes and the timing of the withholding and deposit of the employment taxes.

Proposal

The proposal would amend section 7701 of the Code to provide a definition of an on-demand pay arrangement as an arrangement that allows employees to withdraw earned wages before their regularly scheduled pay dates. The proposal also would amend section 3401(b) of the Code to provide that the payroll period for on-demand pay arrangements is treated as a weekly payroll period, even if employees have access to their wages during the week. Further, the proposal would amend sections 3102, 3111, and 3301 of the Code to clarify that on-demand pay arrangements are not loans. Finally, section 6302 of the Code would be amended to provide special payroll deposit rules for on-demand pay arrangements. The Secretary and her delegates would be provided regulatory authority to implement the Code provisions addressing on-demand pay arrangements.

The proposal would be effective for calendar years and quarters beginning after December 31, 2022.