How to Handle Employee Overpayment

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Utilizing payroll software can help streamline the payroll process and ensure accuracy when employees are paid, but there is still the possibility of error. When an employer accidentally overpays an employee, handling the notification and recovery process can be delicate. Read on to learn how to inform employees about overpayments and what the law says about recovering money that has been paid to employees in error.

What is an Employee Overpayment?

Payroll errors that result in an employee receiving more money than they should have are considered employee overpayments. These errors could happen because of a computer error or a mistake related to the manual entry of pay rates and hours worked by an employee or payroll professional.

It is possible for an employee to intentionally enter additional hours over the time they actually spent working on job tasks in order to receive extra payment. This is considered to be theft of money from the employer.

The information listed below is based on the assumption that an overpayment was not the result of employee dishonesty. Advice and instructions are related to how to deal with employee overpayments when the overpayment was made in error.

How to Approach an Employee Regarding Overpayment

It is generally the responsibility of the employee to notify the payroll department in the case of an overpayment, but the popularity of receiving payments through direct deposit may mean that an employee will fail to thoroughly review a paycheck stub and will miss the error.

Payroll employees that need to approach other employees in regards to an overpayment should first gather as much information about the overpayment as possible. These professionals should be able to pinpoint whether the error was due to a pay rate mistake or a miscalculation of hours worked. The exact amount of the overpayment must be determined prior to contacting an employee in order to recoup the appropriate amount of money.

The best course of action is to put notification in writing with all the relevant information that will keep the employee informed about what the employer intends to do to recoup money. Ask that the notice be signed and returned in order to ensure that the employee has received the notification. A reasonable amount of time to allow an employee to sign and return this paperwork is a period of three weeks.

If the issue has not been addressed by the employee by that time, a payroll employee will need to personally contact the employee either on the phone or in person in order to get a direct response related to the payment discrepancy.

It is possible that both the payroll professional and the employee will be in agreement about the error, but the employee may dispute that there was any error and refuse to repay the amount in question. If this happens, legal action may need to be taken in order to recoup funds owed to the company.

Laws Related to Overpayments

Most cases in which an employee is overpaid allow the employer to treat the overpayment as it would an advance on wages. In other words, the amount that was overpaid would be viewed as a loan that must be repaid by the employee.

Legal issues most often arise when an employee disputes that there was an overpayment or does not agree with the amount that an employer claims was overpaid. If the amount that is owed to the employer is significant, it may be in the employer's best interest to hire a legal professional to resolve the matter.

Legal advice is most often recommended when an employee was paid too much for a long period of time. There have been instances where an employee's paycheck was based on a higher, incorrect pay rate for the entire duration of their employment with a company. This could add up to significant money lost by the company. A full time employee being overpaid by just $1.00 per hour for a period of two years would owe the company over $4,000!

Adjusting Payroll for Overpayments

Provided that both parties agree that there was an overpayment, the employer may deduct the appropriate amount directly from the paycheck of the employee. The amount of time it takes to deduct the amount owed to the employer due to overpayment of wages depends on how much was overpaid. For example, an overpayment of $50.00 may be deducted at one time, but $500.00 might need to be staggered over the course of several months to avoid causing the employee financial hardship.

Some employers may choose to allow employees to decide to trade in paid time off in order to avoid having to have wages reduced in order to make up for the additional compensation that was made in error. For example, an employee who now owes his employer $160 and is compensated at a rate of $20.00 per hour may choose to give up eight hours of paid vacation to avoid paycheck deductions.

Complications may arise if the employee has been fired or otherwise left the employer since the payroll error was made. The payroll department must calculate an exact amount that the former employee owes. After this amount has been determined, a formal letter will be sent to the former employee. The employee is then required to remit payment to the payroll department.

Employers can inform former employees that they may be able to reduce their income tax liability by claiming a credit for the amount that was repaid. However, the credit may not be claimed until the repayment has been completed.

Failure to repay the money that is owed to a former employer can result in the amount owed going into collections. As with any other debt situation, employers are given remedies under the law that are meant to help them collect money that is owed to them. Once notification has been made, time has elapsed in which the former employee could have made payment and warnings related to collections proceedings have been sent, employers may hire professional collection agencies in order to pursue repayment of the amount that was overpaid.

Some states have laws related to deductions for loans made by an employer that could make this process more complicated. For example, California only allows employers to make such deductions if both parties are in agreement and there is signed documentation that the employee has been notified regarding the deduction. California also stipulates that these deductions may not cause an employee's pay to fall below minimum wage.

Employers must consult state law to determine whether deductions are permitted prior to making such a deduction to avoid legal repercussions. The advice of a lawyer may be necessary to determine what is allowed in a specific location.

Tax Implications of Employee Overpayments

Income tax considerations are generally the responsibility of the employee when an overpayment has been made. The employee may be eligible to recover taxes paid on money that was later repaid to an employer by claiming a credit for the tax year during which the amount was repaid.

Since the employer likely already withheld FICA taxes and remitted payment to the IRS, the employer would need to contact the IRS in order to receive a refund for these taxes. Form 941-X is used to file for a refund of FICA taxes. This form can be found on the website of the IRS or may be requested from an IRS representative.

Preventing Employee Overpayments in the Future

Employers can be proactive about avoiding such errors in the future by reviewing pay scale information, vacation requests and holiday pay settings on a regular basis. Any requests for time off that involve unpaid leave should be properly processed as soon as they are received in order to ensure that employees are not paid during the period of unpaid vacation or leave. Instead of granting unpaid time off and updating payroll software accordingly when the time for leave arrives, enter the information immediately to avoid careless mistakes attributed to forgetfulness.

Some overpayments are completely unavoidable, so employers need to understand how to handle the situation in case it does happen. For example, employers that offer bonus payments to employees that are contingent on continued employment may find themselves requiring a repayment from an employee who decided to leave the company after the bonus was dispersed.

Recovering amounts that were overpaid to an employee is typically a painless process that simply requires thorough paperwork and filing forms with the IRS, but legal counsel may be needed if the employee is not cooperative in regards to repayment. Employers should keep accurate records of overpayment calculations and notifications sent to employees in case problems arise while the amount is being repaid. State laws must be taken into consideration when deductions are made in order to recoup money lost due to a payroll error.