How Payroll Works

Historically there have been many ways to get paid. Probably the most basic form of wage is known as **piecework**, and payment is based on work done. This form of payment has frequently been used for agricultural workers or those employed in simple manufacturing processes. The number of cabbages picked or the weight of Brussel sprouts is easy to quantify as is the number of wooden pencil cases assembled.

The next form of payment is often used for manual / menial labourers and is specifically known as a **wage** (even though **wages** has always been the generic term for any payment received from an employer). Wages are generally set at an hourly rate (which in Britain has a defined minimum based on age) and paid weekly and historically as cash although with digitisation this has pretty much been phased out.

The next two forms are often confused, the first being the **salary** and the second being **four-weekly**. The fundamental difference is that the four weekly option results in 13 payments a year rather than 12. Four weekly wages are calculated on an hourly basis and are fundamentally similar to weekly wages only with a different payment frequency. Salaries have historically been the reserve of professionals; that is managers, educationalists or specialists in their field. Salaries are agreed between employees and employers on the basis of an annual total which is then divided into 12 equal payments.

In recent years the so called **zero hour** contract has become increasingly popular and has brought controversy with it. The zero hour contract services what has become known as the **gig economy** and principally it means that although essentially treated as employees, staff – in a similar way to sole traders – only get paid for what they actually do. Management or unscrupulous **employers** can increase or reduce their hours with impunity and because gig workers are legally categorised as **self-employed** they often receive less than the minimum wage as work is given on the basis of the lowest bid. They have very little legal protection because of their status and are in danger of being the most exploited of all employees who are subject to every whim and tantrum of their supervisor. Particularly affected 'employees' are Uber type of workers (whether running taxis or food delivery services) and menial workers such as cleaning staff.

All of these forms of payment can be subject to **performance bonuses** and for those working in certain industries **tips** can also top up income. For those who work in **sales** they are often paid on a **commission** basis (usually an agreed percentage of sales achieved). There are two ways that commission works; firstly a **basic**

wage with a commission and secondly **commission only**. In the second case an employee can receive nothing if no sales are made. An obvious example of this kind of worker is a car salesperson, but may also apply to estate agents and window sellers, etc.

However payment is received, it is all **liable** to **deductions** that break down into three basic categories, governmental **taxes** and **insurances**, known as **compulsory deductions** and other deductions known as **voluntary** or **non-compulsory deductions**. Earnings before deductions are knows as the **Gross Income** and after deductions the remaining amount is known as the **Net Income**. Calculations are based on **Gross** figures Different countries have different regimes on how these funds are collected and this article with look at the UK model, and many of the terms will be transferable across other systems.

Tax

Every UK taxpayer receives a **National Insurance Number** (NIN) around their 16th birthday and a tax code once they start working. The tax code is usually denoted by series of numbers and a letter. The letter defines the taxpayer's status, depending on the tax band they fall into and the number refers to the taxpayer's **free allowance** (more on this below). Tax is collected at the same frequency that the employee is paid on the **PAYE** (**Pay as you earn**) system and there is no need for an employee to complete a tax return at the end of the year. Due to the possibility of error additional tax may be liable but this is rare and it is more likely an employee with receive a **rebate** as the consequence of overpayment of tax, particularly if an **emergency tax code** has been used.

Emergency Tax

M1 and W1 codes are applied when emergency tax is applied. **Emergency tax** is normally applied when a person is starting work for the first time or transferring to another job and no tax code has been allocated. This makes the employee's entire earnings liable for tax as no **free allowance** has been allocated. Once the tax code has been defined such employees have their overpayments **rebated**.

K-Codes

If employees receive, in terms of **perks** and **benefits**, more than they earn in terms of money they can also be taxed on these extras. In others words they are taxed on more than they earn. Employees who receive company cars (when they don't have to take care of maintenance or especially when they get a generous fuel allowance), **club benefits** and **share options** are those who most frequently fall into this category.

How tax is applied

The tax liability is then broken down into a range of brackets, based on the **Gross Income**. In the UK at the time of writing it is as follows.

Free Allowance	tax free income	Up to £12,500
Basic Rate	20%	£12,501 - £50,000
Higher Rate	40%	£50,001-£150,000
Additional Rate	45%	over £150,000

These allowances are then divided according to payment frequency and set out as in the examples laid out in *Figure 1*. In each case the tax code is standard and the free allowance is £12,500. In the last case the employee is subject a K-Code because of perks and benefits to the value of £12,000 per year, but for simplicity the standard tax code has been maintained. Please note the mathematical discrepancies are deliberate as income is rounded down for tax purposes.

National Insurance

National Insurance Contributions (**NICs**) are payable on the Gross income and the form a combined total made up of **employee and employer contributions**. Employers pay a standard 13.8% whereas employees fall into a range of categories and pay a banded amount that is calculated in a similar way to taxation. A quick glance at the UK Government website (refer to *Figure 2*) shows this.

National Insurance contributes to health care and the state pension. To be entitled to the full state pension an employee is required to have 35 full years of national insurance contributions. Any failure to do this will result in a reduction of the state pension received.

Voluntary / Non-Compulsory Deductions

These are contributions that are not legally binding and the employee enters into them by choice. Usually they are for **subscriptions** such as **union membership**, **insurances** and **pensions** and they are frequently **semi-fixed** amounts (the premiums may be relatively static but will increase annually or at other regular periods). These are not the same as direct debits or standing orders as they are deducted before the employee receives payment into a bank account.

Finally all of the given information applies to employees. Company owners are subject to a different tax and national insurance regime.

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