2-1 Earned Income and Benefits

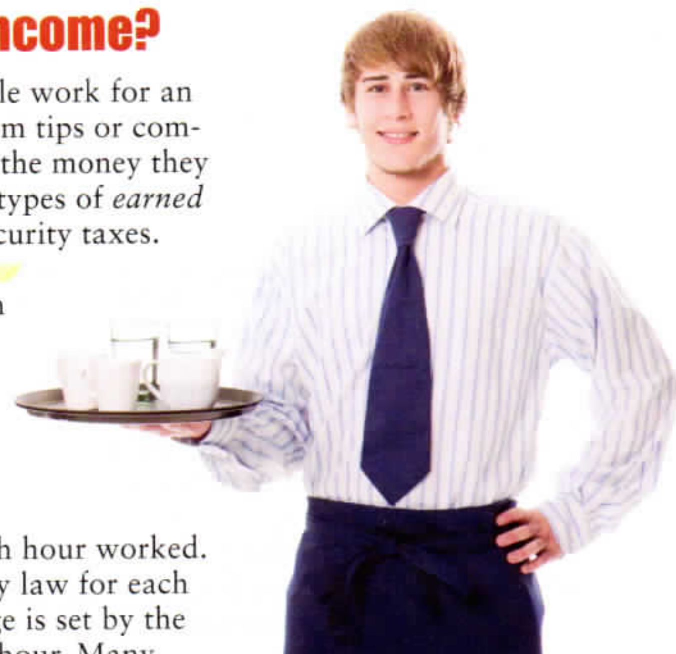
GOALS

- List and discuss types of earned income, such as wages, salaries, tips, and commissions.
- Discuss the advantages and disadvantages of self-employment.
- Describe employee benefits and their role in employee compensation.

KEY TERMS

What Are Sources of Earned Income?

Many people work for hourly wages. Some people work for an annual salary. Others have additional income from tips or commissions. Some people work for themselves, and the money they earn is called self-employment income. All these types of *earned income* are subject to income taxes and social security taxes. A *tax* is a required payment for the support of a government. The tax may be based on items such as earnings, property values, or the sales price of an item. More information about taxes is provided later in this chapter.



What sources of income are available to you?

WAGES

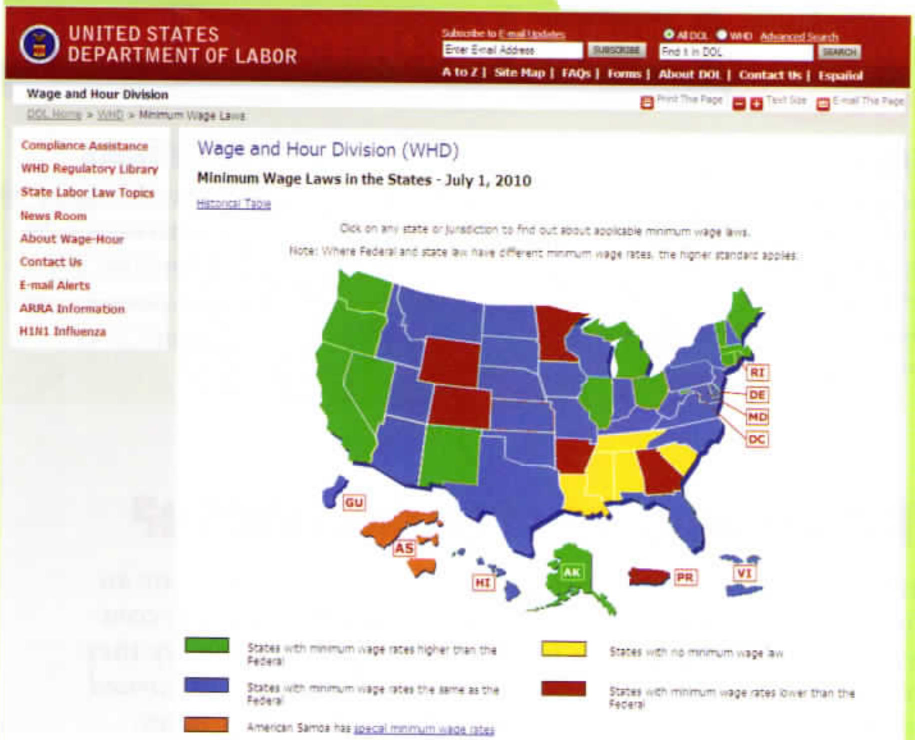
Employees who work for wages are paid for each hour worked. **Minimum wage** is the lowest pay rate allowed by law for each regular hour of work. The federal minimum wage is set by the U.S. Congress. In 2010, that rate was $7.25 per hour. Many states have minimum wage laws that set a rate higher than the federal rate. The state minimum wage rates can be found on the U.S. Department of Labor website as shown in Figure 2-1.1. In many jobs, new employees will begin at minimum wage, because they do not yet have the education or experience to command a higher wage rate.

minimum wage the lowest pay rate allowed by law for each regular hour of work

An 8-hour day and 40-hour workweek has become the standard in the American workplace. Hours worked in addition to the standard are called overtime hours. When employees must work overtime hours, they are entitled to extra pay called **overtime pay**. By law, overtime pay must be at least 1½ times the regular rate. For example, a worker who earns $8 per hour for regular pay would earn $12 per hour ($8 × 1½) for overtime pay. People who work on holidays may be entitled to even higher pay rates for their hours. Both federal and state laws control when extra pay is required for additional time worked.

overtime pay pay received for hours worked in addition to regular hours

Figure 2-1.1 U.S. Department of Labor Website



Source: United States Department of Labor, Wage and Hour Division, http://www.dol.gov/whd/minwage/america.htm.

SALARIES

Some people work for a set *salary*, such as $3,000 a month or $36,000 a year. Salaried workers usually do not keep time cards or count hours worked. They may have more flexibility in the times they work than do hourly workers. They often work more than 40 hours a week but do not receive overtime pay. People who work for a salary are usually self-directed. Managers and supervisors are typically paid a salary.

TIPS AND COMMISSIONS

Some workers receive tips in addition to wages. A *tip* is a gift of money, often a percentage of the total bill, to a person for performing a service.

NET Bookmark

Do you tip well when you visit a restaurant or have your hair cut? Many service employees depend on tips for the bulk of their income. Access **www.cengage.com/school/pfinance/pfl** and click on the link for Chapter 2. What is the definition of a *tipped employee*? What is the minimum required hourly wage for tipped employees?

www.cengage.com/school/pfinance/pfl

Success Skills
TEAMWORK

During your lifetime, you will be on many teams. Whether you are taking part in a family event, a competitive sport, a work group, or a fun activity, teamwork skills will come in handy. Combining the energy of many people makes the work go faster, and the result is often more creative. When you work with others, you can achieve better results than when you work alone. Whenever you work with others to achieve a common goal, try to follow these team strategies to improve your teamwork skills:

- Set clear goals for the team. Create an action plan to achieve the goals.
- Define the duties of each team member.
- Identify how success will be measured. How will the team know it has met its goals?
- Identify problems the team may face in achieving its goals. Discuss ways to overcome them.
- Talk with all team members. Have regular meetings to track team progress.
- Build on the strength of team members. Encourage all members to help make decisions and to share ideas. Each member has different skills that add strength to the team.
- Recognize accomplishments of team members as well as the team as a whole.
- As an individual team member, earn trust by completing your duties. Show a positive attitude when discussing team activities. Be loyal to your team members.

Think Critically

1. Describe the last group (team) you worked with on a project or assignment. List the successful team strategies that resulted in success. Which ones could have been improved?
2. When you fill the role of team leader, how will you improve teamwork using the strategies listed above?

The amount of the tip may be based on the quality of service provided. For example, a waiter may receive tips in the form of money from customers. A caddy at a golf course might receive free tickets to a show as a tip. Some workers make most of their earnings from tips rather than hourly pay.

Tips are subject to federal income taxes. Tips may be subject to state taxes as well. The law requires some employers (such as restaurants and hair salons) to withhold taxes based on tips, even though tips may have been received in cash directly from customers.

Some workers are paid a commission. A **commission** is a set fee or a percentage of a sale paid to an employee instead of or in addition to salary or wages. Sales commissions are earned only when a sale is made. If no sale is made, no commission is received. In some types of jobs, such as real estate sales, the worker's entire earnings may be based on commission. For example, a real estate agent who sells a home for $200,000 might receive a $12,000 commission. In other types of jobs, workers may be paid a base salary plus commissions. For example, a person who sells cars might receive a salary of $10,500 a year plus 25 percent of the profit on each car sold.

commission a set fee or percentage of a sale paid to an employee instead of or in addition to salary or wages

CHECKPOINT

How is overtime pay different from regular pay?

What Is Self-Employment?

entrepreneur a person who takes the risks of being self-employed and owning a business

Working for yourself is called *self-employment*. A person who takes the risks of being self-employed and owning a business is called an **entrepreneur**. Small businesses contribute billions of dollars to the U.S. economy and employ more workers than all of the country's large corporations combined. Owning a business can be challenging, but it can be very rewarding as well.

ADVANTAGES OF OWNING A BUSINESS

A major advantage of being the owner is that you get to make the decisions about how the business will be run. The owner can say what the business will and will not do. This includes the choice of products and services that will be offered. It also includes hours of operation, the types of customers the business will target, and the prices it will charge.

As a small business owner, you have the freedom to set your own hours, deciding when you will work and how long you will work. Small business owners also keep all the profits of the business. *Profit* is the amount left after all expenses are deducted from the revenues or sales of the business.

DISADVANTAGES OF OWNING A BUSINESS

If the business fails, the money invested in the business is lost. Most money invested in a small business comes from the owner and/or the owner's family and friends.

Owning a small business is often risky because it is hard to get credit. In many cases, the owner uses his or her personal credit, including credit cards, home equity, and loan debt in order to get and keep the business running.

With most small businesses, and especially during its first years, the owner works long hours and does many different tasks to keep the business running. Because money is often tight, owners cannot always hire others to do the work for them.


©Corbis

Would you like to own your own small business? Why or why not?

TYPES OF SMALL BUSINESSES

There are two main types of small businesses: lifestyle businesses and venture businesses. A *lifestyle business* is one where the owner intends to keep the business small. The business provides a good income for the owner and his or her family. These businesses exist for the lifetime of the owner and often have no resale value. For example, a dentist may elect to be a one-dentist office and provide services to his or her patients. When the dentist retires, the business closes. Some entrepreneurs have their businesses "on the side." This means they work a full-time job for someone else and pursue their *avocation*—a secondary occupation they enjoy—in their spare time. Their avocation may also bring them a nice "side income."

Other business owners want their businesses to grow into large companies with unlimited growth and many workers. This type of business is called a *venture business*.

As it continues to grow, it will eventually become a corporation. For example, Phil Knight started a business designing tennis shoes in his garage in Eugene, Oregon. When the company grew, it eventually became the publicly held corporation known as Nike. A venture business owner has an "exit plan" so that others can continue operation of the business when the owner decides to leave. The business owner simply may become one of the many stockholders and will no longer have total control of the business.

GETTING STARTED IN BUSINESS

Certain cultures seem to encourage entrepreneurship more than others, and people whose parents owned small businesses are much more likely to start a business than those whose parents worked for someone else. Working for your parents and watching their example can certainly provide an edge. Many entrepreneurs start out working for other businesses in order to gain needed knowledge and experience. Many business owners seek formal and/or informal education about how to run a business before they get started.

If you have a desire to run your own business, you should spend time preparing yourself for such a venture. A good place to start is to talk with the advisers at a Small Business Development Center (SBDC). These centers are located in cities across the country and are sponsored and funded by the Small Business Administration (SBA). A visit to the SBA's website can help you get started asking the right questions. Figure 2-1.2 shows the website for the SBA and some of the services offered.

Figure 2-1.2 SBA Website

Source: U.S. Small Business Administration, http://www.sba.gov.

How can you decide if being an entrepreneur is the right career for you? Your answers to the questions that follow will give you a better idea of whether or not you should consider owning your own business.

What traits do you have that could help you become a successful entrepreneur?

1. Are you self-motivated? If you can get going and do what you need to do without being told or reminded, you will make a good entrepreneur.
2. Do you like people? If you like people and can get along with your customers, you have a good chance of success.
3. Are you a leader? Entrepreneurs are able to get others to follow their lead. They are confident and persuasive.
4. Do you take responsibility? Entrepreneurs take charge and follow through.
5. Are you organized? Business owners must have a good plan before they get started. They line up their resources, fill in the gaps, and charge forward.
6. Do you work hard? To be a successful owner, you must set the pace by example. Business owners work many long, hard hours. They don't expect others to do what they themselves are unwilling to do.
7. Do you make decisions easily and quickly? Owners must take risks and be willing to accept the consequences. Decisions sometimes have to be made without complete information.
8. Are you trustworthy? Others must trust you and accept that you know what you are talking about. This means building trust and long-term relationships.
9. Are you persistent? Business owners stick with it, even when the going gets tough. They finish projects and forget about excuses.
10. Do you keep good records? Entrepreneurs must account for their costs and their revenues. They must pay taxes and understand about profitability and cost analysis. These things require complete and accurate records.

If you have a good business idea, you should start the process early. Get your thoughts and plans onto paper, get advice from those you trust, and work toward your dream of owning your own business. In putting your idea into writing, you will be starting your business plan. A *business plan* is a document that describes the steps that will be taken to open and operate a business. It should show that you are worthy of funding (loans) from government and private sources, such as banks and venture capitalists. Sample business plans can be found at the SBA website or at various other websites by conducting an online search using the keywords *business plans*.

CHECKPOINT ▸ ▸ ▸

Why would a person want to be an entrepreneur?

What Are Employee Benefits?

Full-time workers usually have benefits provided by the employer. **Benefits** are forms of pay other than salary or wages. Paid vacation and holidays are examples of benefits. Some benefits are paid for by the company. For other benefits, such as health insurance, the worker may need to pay part or all of the cost.

benefits forms of pay other than salary or wages

A *cafeteria plan* is a benefit plan that allows workers to choose from a number of options. Workers may be able to save money by selecting only the options they need. Most plans include basic choices for health, life, and other insurance. Other options, such as a savings plan, may also be available.

Benefits increase the overall value a worker receives from a job. **Disposable income** refers to the money a person has available to spend or save after taxes have been paid. Money received from some benefits, such as a profit-sharing plan, can directly increase a worker's disposable income. Other benefits have the effect of indirectly increasing disposable income. For example, health insurance bought through a company plan may be cheaper than an individual policy. The money saved by joining the group plan is available to spend on other items.

disposable income money available to spend or save after taxes have been paid

Benefits are also important to workers for several other reasons:

- Workers are not taxed on most benefits. This means that workers receive something of value without paying tax as part of the cost.
- Some benefits allow workers to buy services at a cheaper price than they could otherwise. For example, group insurance costs much less than an individual policy. Paying a lower cost for insurance increases the worker's disposable income.
- Some benefits offered to workers may not be available to individuals, such as company retirement plans and stock options.
- Some benefits offered to workers may not be affordable at individual prices. For example, workers who have health problems might not be able to afford insurance at individual rates or may even be denied coverage at all.
- Some benefits help workers reach financial goals. For example, some people find it hard to save money. With company-sponsored savings plans, saving becomes easier because the money is automatically deducted from the worker's paycheck. Some savings plans have tax-savings features, and companies often match employees' contributions to the plan up to a certain amount.

PAY WITHOUT WORK

Pay without work refers to times when an employee who is not working will be paid. Paid vacations, holidays, and sick leave are examples of pay without work. Full-time and salaried employees usually get annual paid vacations. Typically, after the first year, an employee gets one to two weeks of vacation a year.

Most employers provide certain *paid holidays*. Examples of paid holidays are Thanksgiving Day, Christmas Day, and Labor Day. On those days, employees will be paid but will not have to work. Employees who do work on holidays may receive extra pay—typically two times the regular rate.

sick leave paid time away from work due to illness

personal leave paid time away from work for personal reasons

Many companies allow workers to take a certain number of sick days per year. **Sick leave** is paid time away from work due to illness. Some companies allow the use of sick leave to care for a sick child or other family member. Typically, an employee is allowed up to 10 paid days of sick leave per year. Some companies allow unused sick leave to accumulate. That means that workers can save sick leave not used in one year and have it available for use in another year in the case of extended illness.

Some employers also offer personal leave. **Personal leave** is paid time away from work for personal reasons. The worker usually does not have to give a reason. Typically, two or three days a year are granted for personal leave. Unused personal leave is generally not carried forward to another year.

These and other pay-without-work benefits allow employees to rest, take care of personal business, plan family vacations and special events, and get away from work pressure and stress, all of which are part of a balanced and healthy life.

EDUCATIONAL BENEFITS

Some employers provide plans that will pay for, share the cost of, or reimburse (pay back) money spent on education. For example, some companies pay for the cost of classes or training related to the worker's job. This training can benefit both the company and the employee, who may be able to perform better using the skills learned. With additional education or training, the employee may also have improved chances of getting a promotion or a better job with the same or a different company. Some employer plans will even pay for classes taken to earn a college degree, which is a benefit of great value, now and in the future.

In a typical education plan, the employee will be repaid 100 percent of the cost of tuition and books if an A grade is received in the class. If the employee earns a B grade, 90 percent of the costs will be repaid. If the employee earns a C grade, 80 percent of the costs will be repaid. If the employee's grade is below a C, no costs will be repaid.

© Monkey Business Images, 2010/Used under license from Shutterstock.com

Why do some employers offer educational benefits?

PERKS

Providing high wages and good benefits, such as pay without work and education plans, is one way that companies motivate employees. Other types of benefits, called *perks*, have a different value. They provide emotional satisfaction or social status rather than money. Examples of perks are a prime parking space, an office with a view, an expense account, and a company car. Some of these benefits are not taxable, adding to their value. When perks are taxable, they are considered a part of an employee's basic compensation package.

INSURANCE

Health insurance is an important benefit for many workers. The price paid for health insurance is called a *premium*. In the past, many employers paid the full premium for employees. The costs of health care have risen steadily over the past several years and are expected to continue increasing. Today, employees typically pay a portion or all of their insurance premiums through payroll deductions. Being able to participate in the company-offered group plan is a benefit in itself because group rates are typically much lower than those for individual policies and acceptance into the program is guaranteed. The premiums vary depending on the coverage provided. An employee with a spouse and children would pay more than a single employee. Dental or vision care insurance may also be available.

Group life insurance is often available at work. The premium may be paid by the employer or the employee. In some companies, the employer pays for a certain amount of life insurance, such as twice the employee's annual salary. The employee may be able to purchase additional coverage at the group rate. Life insurance paid for by the employee may be *portable*, which means the employee may be able to continue the policy after leaving the employer.

Disability insurance provides payments to replace income lost when illness or injury prevents the employee from working. It is an option for many employees. Coverage for short-term disability (up to two years) is often paid for by the employer. Long-term disability insurance typically covers periods longer than two years and up to retirement.

Workers' compensation is an insurance plan that employers are required by law to provide for employees. It pays medical and disability benefits to workers who are injured or contract diseases on the job. Benefits may also be paid to the worker's family if the worker is killed on the job.

RETIREMENT PLANS

Many companies offer 401(k) retirement plans. A **retirement plan** is an account into which employees contribute a portion of their earnings for their retirement. The employer may or may not make a matching contribution. This type of plan is tax-deferred, or pretax, meaning employees can avoid paying income tax on the money in the account until it is withdrawn. Contributions to the account are automatically deducted from the employee's paycheck.

retirement plan an account into which employees contribute a portion of their earnings for their retirement; employers may match these contributions

Some companies offer retirement accounts called *pension plans* that are paid entirely by the employer. Pension plans provide payments to retired workers. Typically, employees must work for the company for a certain number of years to qualify. The payment amounts vary depending on the number of years worked, the worker's salary, and other factors. This type of benefit is being phased out by most companies in favor of the 401(k) retirement plan.

PROFIT-SHARING PLANS

A **profit-sharing plan** allows employees to share in the profits of the business. The plan may pay a bonus of a specified percent of the

profit-sharing plan a benefit whereby employees may share in the profits of the business employee's salary if the business meets or exceeds its financial goals. The bonus may be paid in cash, or it may be added to a retirement account. If paid in cash, it is taxable in the year received. If added to a retirement account, it is taxed when withdrawn by the employee. Profit-sharing plans help motivate employees to achieve company goals.

STOCK OPTION PLANS

Some companies allow employees to buy stock in the company at a reduced price. The purchase price of the stock may be deducted from the employee's pay. This is a convenient way to acquire stock, and it does not involve brokerage or trading fees.

HEALTH SPENDING ACCOUNTS

A health flexible spending account (often called a *Flex 125 plan*) allows employees to set aside money (pretax) to pay for qualified medical expenses. The plans are often set up by employers as an employee benefit. Deductions are made from the employee's pay to fund the account. The employee files claims for qualified expenses to be paid from the account. The major disadvantage of the Flex 125 plan is that, if the employee does not use the money in the account by the end of the year, he or she loses it (to the employer). Because the money cannot be carried forward to the next year, the employee must carefully estimate what the medical expenses will be each year.

A *health savings account* (*HSA*) can be used by employees who have high-deductible health insurance plans. High-deductible plans are becoming more popular because their premiums are lower. Employees can set aside money (pretax) in an HSA to pay for qualified medical expenses not covered by insurance. The employer may also contribute a monthly amount to the HSA. HSAs are usually managed by banks or investment companies. Money put into the accounts gain interest or earnings based on how the money is invested. Typically, medical expenses are paid using a debit card that accesses the HSA. Money in an HSA that is not used by the end of the year can be carried forward to the next year. When employees leave the job or retire, they can take their HSA with them and continue to use it for medical expenses.

OPTIONAL DEDUCTIONS

Most employers also allow their employees to have other amounts withheld from their paychecks. For example, employees may wish to donate money to a charity or to put money into self-managed savings or investment accounts. The employer withholds money from the paycheck (usually after taxes have been paid on it) and sends it to the designated source.

CHECKPOINT ▸ ▸ ▸

Why are benefits an important part of a compensation package?