

States Facing Escalating Unemployment Taxes Might Find Relief in Current Federal Law and 1980's Laws

- As of January 5, 2010, 26 states had borrowed more than \$27 billion from the federal government in order to finance their unemployment benefits. This number is projected to soar over the next few years as the U.S. Department of Labor has projected some 40 states will borrow up to \$90 billion by the end of 2012
- As state legislatures convene their 2010 sessions, the issue of how to repay the loans and the impact on employers will be debated in state capitols across the country. If states are unable to repay their loans within two to three years, a federal tax imposed on the states' employers will increase automatically.
- **What is the federal tax?** Pursuant to the Federal Unemployment Tax Act (FUTA), a tax is levied on covered employers at a rate of 6.2 percent on wages up to \$7,000 a year paid to an employee. However, FUTA provides a credit against the federal tax of 5.4 percent to employers in states with an approved state unemployment insurance (UI) program and no overdue federal UI loans. All state programs are approved. Accordingly, in states with no overdue loans, employers pay a federal tax rate of 0.8 percent, or a maximum \$56 per covered employee, per year.
- **How is the tax increase calculated?** If states do not repay their loans within two to three years, the FUTA tax rate will increase on the states' employers (known as a FUTA credit reduction). Each year the loans are overdue, employers can lose at least 0.3 percentage point from the federal credit, which increases the net tax rate by 0.3 percentage point in the first year it is overdue (for a tax rate of 1.1 percent), 0.6 percent in the second year it is overdue (for a tax rate of 1.4 percent), and so on until the loan is repaid.
- **How can states find relief from the tax increase?** Measures in permanent law allow a state's employers to avoid the FUTA credit reduction entirely or cap the reduction at a specified level if the state meets criteria meant to improve the long-term solvency of their unemployment insurance trust funds and assist them in the repayment of federal loans.
- A temporary law enacted in the 1980's authorized special partial caps to the FUTA credit reduction for states that met some of the criteria necessary to receive a full cap on the level of the FUTA tax increase.
- Many states facing FUTA tax increases in the 1980's benefited from these permanent and temporary measures. States with overdue outstanding loans in the coming years might use these provisions in the future.
- The attached document explains how the automatic tax increase will occur and details the permanent measures that can provide states some relief from the tax increases. In addition, the document provides information on temporary measures enacted in the 1980s that no longer are in federal law.

Source: *National Association of State Workforce Agencies (NASWA)*

Federal Unemployment Tax Act (FUTA) Credit Reduction

BACKGROUND: The recession of 1981 – 1982 lasted for a total of 16 months; eroding the U.S. labor market with record – high layoffs that led to the highest national unemployment rate in recorded history and an increased number of unemployed workers receiving state unemployment benefits. Many states, having just recovered from the 1973 – 1975 recession, were unable to finance their state Unemployment Compensation (UC) benefits and were forced to borrow from the federal government. By the end of 1983, a total of 23 states had borrowed several billion dollars from the federal government and were unlikely to repay the advances in the near future. In response to the inability of states to repay these advances, Congress passed a series of laws from 1981 – 1983 (some permanent and others temporary) to assist states in the repayment of these federal advances if states adopted certain measures to ensure the long-term solvency of their unemployment insurance trust funds. The following summary describes these permanent and temporary measures.

PERMANENT LAW

FUTA Credit Reduction (Section 3302(c), FUTA): Employers in states with outstanding federal advances face increases in their FUTA tax rate stemming from automatic reductions in the FUTA credit. If a state has an outstanding balance on January 1st of two consecutive taxable years, its employers' FUTA credits will be reduced, unless the outstanding balance is paid in full before November 10th of the second year. The basic credit reduction is 0.3 percentage points for the second year and it increases by 0.3 percentage points each subsequent taxable year there continues to be an outstanding balance. Additional credit reductions may occur in future years. During taxable years beginning with the third and fourth consecutive January 1st in which the state continues to have an outstanding balance, its employers could face reduction in credits based on the state's average tax rate (the 2.7 Add-on). Should a state continue to maintain an outstanding balance for a fifth or successive January 1st, its employers would face an additional credit reduction equal to the greater of the 2.7 Add-on or a reduction based on the state's 5-year average cost (Benefit Cost Rate Add-on).

Avoiding the FUTA Credit Reduction (Section 3302(g), FUTA): The federal government will waive the FUTA credit reduction applied against a state's employers in a year if the state meets all of the following criteria:

- (1) Repay all advances for the most recent one-year period ending on November 9;
- (2) Make a voluntary repayment equal to the potential additional taxes that would have been imposed for the taxable year;
- (3) Have reserves in the state unemployment trust fund sufficient to pay all unemployment compensation for the three-month period beginning on November 1st without obtaining additional advances; and
- (4) Alter state law to increase net solvency of its unemployment trust fund (UTF) in an amount equal to the potential additional taxes.

Two states (MI and WI) fulfilled these criteria and were not subject to reduced FUTA credits in 1986. In 2005 and 2006, Missouri fulfilled these criteria and was not subject to reduced FUTA credits.

Full Cap on Credit Reductions (Section 3302(f), FUTA): A state may qualify for a cap on the FUTA credit reduction applied against its employers (at the higher of 0.6 percentage points or the state's rate for the prior year) by meeting all of the following criteria:

- (1) No state action is taken during the 12-month period ending on September 30 of the taxable year resulting in a reduction in the state's tax effort;
- (2) No state action is taken during the 12-month period ending on September 30 of the taxable year resulting in a net decrease in the solvency of the state's unemployment compensation system;
- (3) The state's average tax rate on total wages equals or exceeds the five-year benefit cost rate on total wages; and
- (4) The state's outstanding balance on federal advances on September 30 of such taxable year is not greater than the outstanding balance on federal advances on September 30 of the third preceding taxable year.

Seven states (CT, DE, NJ, PR, RI and VT) qualified for the full cap in 1983; four states (CT, NJ, PR and VT) qualified for the full cap in 1984; and three states (CT, PR and VT) qualified for the full cap in 1985.

TEMPORARY LAW

Partial Caps on Credit Reductions (Section 3302(f)(8), FUTA): Amendments to the Social Security Act temporarily authorized special partial caps to the FUTA credit reduction (but not below the higher of 0.6 percentage points and the rate for the prior year) for tax years 1983, 1984 and 1985.

- **For a reduction of 0.1 percentage point:** A State must have met the requirements of (1) and (2), and (3) or (4) of the criteria necessary to qualify for the full cap (outlined above).
- **For a reduction of an additional 0.1 percentage point:** A State must have met the requirements of (1) and (2) of the criteria necessary to qualify for the full cap (outlined above). Additionally, the state must have taken action to increase revenue liabilities and decrease benefits under the state's unemployment compensation system, or had an average unemployment tax rate equal to or greater than 2.0 percent of total wages.

Three states (DC, IL and PA) qualified for a partial cap in 1983; seven states (DC, IL, MI, MN, OH, PA and WV) qualified for a partial cap in 1984; and four states (IL, OH, PA and WV) qualified for a partial cap in 1985.

Source: House Committee on Ways and Means Green Book (Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means) 1980 – 1990. States not included in the chart did not experience a FUTA credit reduction during this time frame.

FUTA Credit Reductions by State 1981 - 1987

STATE	1981	1982	1983	1984	1985	1986	1987
Arkansas			0.6				
Connecticut	0.7	0.7	0.7	0.7	0.7		
Delaware	0.6	0.6	0.6				
District of Columbia	0.6	0.6	1.1	1.1			
Illinois	0.3	0.6	0.7	0.8	0.9	1.2	
Iowa				0.3			
Kentucky			0.3				
Louisiana				0.3	0.6	0.9	
Maine	0.3	0.9	0.9				
Michigan			0.6	0.7			
Minnesota			0.6	1	1.1		
New Jersey	0.3	0.6	0.6	0.6			
Ohio			0.6	0.7	0.8	1.1	
Pennsylvania	0.6	0.6	0.7	0.8	0.9	1.2	1.5
Puerto Rico	0.3	0.6	0.6	0.6	0.6		
Rhode Island	0.6	0.6	0.6				
Texas				0.3			
Vermont	0.6	0.6	0.6	0.6	0.6		
West Virginia			0.6	0.7	0.8	1.1	
# of States Facing Credit Reductions	10	10	16	14	9	5	1