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ResearchReport

OLR Backgrounder: State and Federal Unemployment Tax

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Issue

This report describes state and federal unemployment taxes.

Summary

Employers pay both state and federal unemployment taxes to fund the unemployment insurance (UI) system. In general, state UI taxes support the state's unemployment trust fund, which pays UI benefits during an unemployed person's first 26 weeks of unemployment. In Connecticut, an employer's state UI tax rate generally depends on the unemployment benefits paid to the employer's former employees (expressed as its "experience rate") and the solvency of the state's unemployment trust fund (expressed as "the fund balance rate"). The sum of these two rates, which can range from 0.5% to 6.8%, applies against the first $15,000 of each employee's wages (the taxable wage base).

Federal unemployment taxes, paid under the Federal Unemployment Tax Act (FUTA), primarily pay the costs of administering the unemployment system and support a federal fund from which states can borrow (e.g., if their state trust funds become insolvent during severe recessions). FUTA generally requires employers to pay a 6% tax on the first $7,000 of each employee's wages. However, the effective FUTA tax rate is typically only 0.6% due to a 5.4% tax credit that employers receive against the FUTA tax, as long as their state's unemployment system meets various requirements and their state does not have any loans from the federal fund that have been outstanding for more than two consecutive years. When states do not meet these conditions, federal law reduces the credit, thus increasing the employers' FUTA tax rate.

State Tax

Connecticut employers pay state UI taxes to support the state's Unemployment Trust Fund, which provides UI benefits to eligible claimants. An employer's state UI tax liability typically depends on three factors: (1) its experience rate (a tax rate based on the amount of UI benefits paid to its former employees), (2) the fund balance rate (a tax rate tied to the financial solvency of the state's unemployment trust fund), and (3) its taxable wage base (the amount of wages it paid that are subject to state UI taxes).

Experience Rate

In general, an employer's "experience rate" depends on the amount of UI benefits its former employees received over the past three years.

When a UI claimant receives benefits, the benefit amount is based on how much the claimant earned over his or her base period (typically, the first four of the five most recently completed calendar quarters, CGS §§ 31-230 & 31-231a). The benefits received by the claimant are then charged on a pro-rated basis to the "experience account" of each employer who paid the claimant wages used to determine his or her benefit amount (CGS § 31-225a(b)(2)). However, an employer's experience account will not be charged under certain circumstances (known as "non-charges"), such as when the claimant voluntarily left employment with the employer and the employer timely contests the charge (CGS § 31-225a(c)(1)).

The Department of Labor annually determines each employer's experience rate by calculating a benefit ratio for the employer over the previous three years. This is the ratio between the amount charged to the employer's experience account and the amount of the employer's taxable wages (see below). Based on a statutory conversion table, the benefit ratio is then converted to a tax rate which ranges from a 0.5% minimum (for employers whose employees have received the least amount of benefits) to a 5.4% maximum rate (CGS § 31-225a(e)).

For employers to receive the maximum FUTA tax credit, federal law (1) requires that a state's experience rating system use an experience period that is at least three years long (26 U.S.C. § 3303(a)) and (2) prohibits states from setting their maximum experience rates lower than 5.4% (26 U.S.C. § 3302(b)).

The cost of benefits that are paid to a claimant but not charged to an employer's experience rating (e.g., due to a non-charging circumstance or an employer who is already at the maximum allowed experience rate) are ultimately shared by all employers through the fund balance rate.

Fund Balance Rate

In addition to its individual experience rate, each employer is also charged a flat UI tax rate known as the "fund balance rate." Set each year by the labor commissioner, this rate is generally calculated to ensure that the unemployment trust fund maintains a statutorily determined amount of funding in it (a fund balance goal). The fund balance rate cannot exceed 1.4% and if the fund exceeds its goal in any year the commissioner must reduce the next year's rate to eliminate the excess (CGS § 31-225a(f)(1)).

In general, the fund balance goal is an amount that will support paying out recession-level UI benefits for one year. More specifically, the goal is an amount that results in an average high cost multiple (AHCM) equal to 1.0. The AHCM is a formula that expresses how many years the unemployment trust fund can pay out benefits at a recession-level payout rate. If the AHCM is 1.0, the fund should be able to cover one year of benefits in a recession that is the average magnitude of the last three recessions.

To qualify for certain interest-free federal loans, a state's UI trust fund AHCM must have been at least 1.0 for one of the previous five years (20 C.F.R. § 606.32(b)(2)).

The AHCM is determined by (1) expressing the amount in the unemployment trust fund at the end of each calendar year as a fraction of the total wages paid by contributing employers during that year and (2) dividing that number by the average of the three highest annual benefit amounts (expressed as a percentage of the total covered wages) that were paid over the last 20 years or last three recessions, whichever period is longer (CGS § 31-225a(f)(2)).

Taxable Wage Base

An employer's total state UI tax rate is the sum of its experience rate and the fund balance tax rate, and thus can range from 0.5% to 6.8%. This rate is applied to the employer's "taxable wages," which since 1999 has been the first $15,000 of each employee's taxable wages (CGS § 31-222(b)(2)). Thus, for example, an employer with a 6.0% tax rate must pay $900 for each employee that it pays at least $15,000 per year (regardless of whether it pays the employee $15,000 or $150,000).

Federal Tax

FUTA Tax

In addition to state UI taxes, employers must also pay federal unemployment taxes under the Federal Unemployment Tax Act (FUTA). According to the U.S. Department of Labor's Unemployment Insurance Directors' Guide, the federal government uses the revenue from the FUTA tax to, among other things:

1. pay federal and state administrative costs for their unemployment programs,
2. provide federal "extended" UI benefits (when benefit availability is extended beyond 26 weeks under certain triggers),
3. support the federal fund that provides loans to states when their state UI trust funds are unable to pay benefits, and
4. fund employment and training services for veterans.

An employer's annual FUTA tax is generally 6% on the first $7,000 of each employee's annual wages. However, employers typically receive a 5.4% credit against the FUTA tax, leaving their effective FUTA tax rate at 0.6% (typically, $42 per employee).

FUTA Tax Credit Requirements. In order to qualify for the 5.4% tax credit, a state's unemployment system must conform to numerous federal requirements contained in [§§ 3303] and [3304] of the federal Internal Revenue Code. For example, (1) claimants cannot be denied benefits because they refuse to accept work in a job that is vacant as a direct result of a labor dispute and (2) benefits cannot be denied based on a cancellation of a claimant's wage credits or total benefit rights for any cause except discharge for work-connected misconduct, claim-related fraud, or receipt of disqualifying income.

Administrative Grant Requirements. As previously discussed, the federal government returns some of the FUTA tax revenue to the states to pay their costs for administering their unemployment systems. However, to qualify for this federal funding, a state's unemployment system must meet numerous requirements, such as the following:

1. all benefits must be paid through public employment offices or other approved agencies approved by the U.S. secretary of labor;
2. the system must provide fair, impartial hearings for claimants whose UI claims were denied; and
3. all funds withdrawn from the state trust fund may only be used for (a) paying UI benefits, exclusive of administrative expenses, (b) making certain refunds for erroneous payments, and (c) certain other limited activities specified in the law.

Federal Loans

If a state's unemployment trust fund lacks enough funds to pay benefits, federal law allows the state to receive a loan from the federal unemployment fund so it can keep paying UI benefits (42 U.S.C. § 1321).

In the aftermath of the "Great Recession" Connecticut had to borrow nearly $1 billion to continue paying UI benefits. For additional information about how this borrowing affected UI taxes, see OLR Report 2015-R-0275.

However, if the loan remains outstanding after two consecutive years, the law reduces the size of the FUTA tax credit by 0.3% (e.g., from 5.4% to 5.1%) each year that the loan remains outstanding. Reducing the credit correspondingly increases the effective tax rate and the extra revenue generated pays the principal on the loan. Additional credit reductions apply if the loan remains outstanding after three and five consecutive years (26 U.S.C. § 3302(c)).

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