


# Riding the waves of unemployment insurance tax in 2011 and beyond





The ripples of the financial markets collapse of 2008 are beginning to be felt on a broad scale as many State Unemployment Insurance (SUI) trust funds grapple to maintain sufficient balances to pay Unemployment Insurance (UI) benefits. State legislators have creatively pursued options to both increase incoming trust fund revenues and reduce outflows, resulting in a year of unprecedented UI legislation that affects both employers and their employees. With a record-breaking number of states unable to pay off their federal UI loan balances, and numerous employers being asked to foot the states' interest charges on those loans, many employers are also experiencing significant increases in their UI costs, despite the July 1 expiration of the 0.2% "temporary" Federal Unemployment Insurance (FUTA) surtax.

As we have learned from previous recessions, unemployment insurance costs are slow to respond to economic conditions. Just as the recession that began in 2008 is only now having a significant impact on UI costs, conversely, economic recovery takes time to be felt in the form of a drop in UI costs. For these reasons, most employers will be challenged in the next several years to accurately budget their UI tax costs due to the many elements at play in keeping UI trust funds afloat.

House Committee on Ways & Means Chairman Dave Camp (R-Mich.) announced that for the first time since its inception in 1976, the 0.2% temporary FUTA surtax will not be extended.

## FUTA surtax expires – a tax break, at least for now

Prior to the enactment of the “temporary” surtax in 1976, the full FUTA tax rate was 6.0%, and the maximum available FUTA credit for the payment of SUI taxes was 5.4%. Employers made quarterly deposits at the rate of 0.6% and adjusted for any loss in the maximum 5.4% FUTA credit when making the final FUTA payment for the year by January 31 of the following year.

In response to the recession of 1973 through 1975, Congress passed a temporary 0.2% surtax to repay federal general revenues used to provide federal unemployment insurance benefits. Consequently, from 1976 and through June 30, 2011, the full FUTA rate was 6.2%, and after taking into account the maximum FUTA credit of 5.4%, the increased quarterly deposit rate was 0.8%.

Although the general revenues were fully repaid by 1987, the 0.2% “temporary surtax” remained in effect until June 30, 2011. According to the House Committee on Ways & Means, the temporary surtax has raised an additional \$46 billion (adjusted for inflation) above and beyond what was needed since the inception of the surtax in 1976. In its long 35-year life, the temporary surtax has been extended on eight separate occasions, and in some instances was earmarked to fund programs unrelated to unemployment.

House Committee on Ways & Means Chairman Dave Camp (R-Mich.) announced that for the first time since its inception in 1976, the 0.2% temporary FUTA surtax will not be extended. Camp stated in a House Ways & Means news release on June 30, “The fact that it has taken 35 years for this ‘temporary’ tax to expire clearly illustrates the dangers of higher taxes – once in place, they are unlikely to ever go away. We need employers paying more salaries, not paying higher taxes. And when the surtax expires, job creators will get a little and long overdue relief.” In the wake of escalating state-level unemployment insurance taxes, businesses are likely to agree with Camp’s statement that “the death of any tax on jobs – no matter how big or small – is a historic moment and one to be celebrated.” Camp emphasizes that because unemployment benefits are not directly linked to the “temporary” surtax, its expiration will not affect current or future unemployment benefit receipts. (*Press release, House Committee on Ways & Means, Dave Camp, June 30, 2011.*)

Assuming that Congress does not move to reinstate the FUTA surtax this year, the full FUTA tax rate reverts on July 1, 2011 to 6.0%, with the rate for quarterly FUTA deposit purposes reduced to 0.6%. The maximum FUTA credit remains at 5.4% for 2011; however, at least 24 states are currently at risk of losing a portion of this credit because of federal unemployment loan balances they have not yet resolved. (See page 2 for more information on the FUTA credit reduction.)

The expiration of the temporary surtax results in a maximum annual FUTA tax savings of \$14 per employee per calendar year (\$7,000 x 0.2%). However, because most employees reach the FUTA wage limit of \$7,000 in the first two quarters of the year, employers are not likely to realize much in the way of FUTA tax savings in 2011.

### FUTA reporting changes in 2011

The IRS has already made plans to revise the 2011 Form 940, *Employer’s Annual Federal Unemployment (FUTA) Tax Return* to reflect two FUTA tax rates for 2011: 6.2% through June 30, 2011, and 6.0% through December 31, 2011. The IRS reminds businesses of the importance of separately tracking and identifying FUTA-covered wages paid through June 30, 2011, and those paid July 1 through December 31, 2011, as they will need to be reported separately on the 2011 Form 940.

Employers should immediately begin accruing their FUTA tax liability effective with wages paid on and after July 1, 2011, at the rate of 0.6%, with adjustments needed for any loss in the maximum 5.4% credit to be paid with the 2011 fourth-quarter payment due on January 31, 2012. (See page 2 for more information on the FUTA credit reduction.)

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Employers pay the increased FUTA tax caused by the FUTA credit reduction as though incurred in the fourth quarter of the year the credit reduction applies. The additional FUTA tax owed is paid by the due date of the Form 940 (January 31 or the next business day).

In the event that legislation should be enacted later this year to reinstate the 0.2% temporary surtax, IRS officials have stated that employers would not be penalized for the 0.2% tax underpayment provided the shortfall is paid within time frames specified by the IRS.

2011 wage payment period	2011 full FUTA tax rate	2011 FUTA deposit rate
Wages paid January 1 to June 30, 2011	6.2%	1Q and 2Q 2011 – 0.8%
Wages paid July 1 to December 31, 2011	6.0%	3Q – 0.6%*

\* Loss of FUTA credit for states owing on federal loans or employers delinquent in payment of SUI taxes may result in a higher FUTA deposit rate for the fourth quarter 2011.

**Pending legislation to reinstate the temporary FUTA surtax.**

As of the release of this publication, a bill was under consideration (S. 386) that would extend the 0.2% temporary FUTA surtax through 2013. The bill also would impose a reduced FUTA rate of 5.78% and increase the FUTA taxable wage base from \$7,000 to \$15,000 effective in 2014. No action has been taken on this bill since it was submitted to the Senate Committee on Finance on February 17, 2011.

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**Loss in the FUTA credit – the price of federal borrowing**

Federal UI loans are available to the states under Title XII of the Social Security Act to assist them in paying unemployment insurance benefits. If a state with an outstanding federal loan balance on January 1 of two consecutive years fails to repay the entire loan amount by November 10 of the second year, employers in that state are subject to reduction in the maximum 5.4% FUTA credit. The credit reduction increases by an additional 0.3% the next year, with special computation of the credit reduction in years three and thereafter.

From January 1, 2011 to June 30, 2011, the net FUTA deposit rate for employers entitled to the full 5.4% FUTA credit is 0.8%. Hence, a loss in the FUTA credit of 0.3% results in a net FUTA rate of 1.1% for the first half of 2011. A loss in the FUTA credit of 0.6% (for Indiana and South Carolina, since these states are potentially in their second year of credit reduction) results in a net FUTA rate of 1.4% for the first half of 2011, and so on. (See page 1 for information on the FUTA credit.) Employers pay the increased FUTA tax caused by the FUTA credit reduction as though incurred in the fourth quarter of the year the credit reduction applies. The additional FUTA tax owed is paid by the due date of the Form 940 (January 31 or the next business day).

**Release of Form 940 could be delayed for FUTA credit**

**reduction information.** Because the states have until November 10 to repay their federal loans before the FUTA credit reduction applies, the IRS must wait until after November 10 to issue the Form 940 for the tax year. With 24 states potentially having a FUTA credit reduction in 2011, employers should not expect the IRS to release the 2011 Form 940 until early- to mid-December.



## FUTA credit reduction for federal UI loan balances – when they apply and when they are paid

Year of original FUTA loan	Year FUTA credit reduction applies	Due date of increased FUTA tax due to loss in FUTA credit
2007	2009	January 31, 2010
2008	2010	January 31, 2011
2009	2011	January 31, 2012
2010	2012	January 31, 2013
2011	2013	January 31, 2014

### Additional FUTA costs for unpaid federal loans

Number of years of loan balance as of January 1 and not repaid as of November 10	Adjusted FUTA rate in addition to 0.8% (assuming maximum credit otherwise applies)*	Increase over \$56 per employee (assuming \$7,000 x 0.8%)
2	1.1%	\$21
3	1.4%	\$42
4	1.7%	\$63

\*Note that the net FUTA rate is .6% effective July 1, 2011

Michigan was the first state to default on its federal UI loan in 2007 and started borrowing in 2006, two years sooner than the rest of the country began experiencing a significant increase in UI benefit claims. A FUTA credit reduction of 0.3% first applied to Michigan employers in 2009, with payment due by January 31, 2010.

Two additional states took federal UI loans in 2008, and three states had unpaid federal loan balances as of November 10, 2010: Indiana, Michigan and South Carolina. The 2010 Form 940 reflected a credit reduction of 0.6% for Michigan and 0.3% for Indiana and South Carolina respectively. The additional FUTA tax owed was required to be paid by January 31, 2011.

The American Recovery and Reinvestment Act (ARRA) of 2009 included a provision that for tax years 2009 and 2010 allowed the states to take interest-free federal UI loans. (See page 7 for more information concerning federal UI loan interest.) Undoubtedly, the waiver of interest made federal borrowing an attractive alternative to other means of financing unemployment benefits, and consequently, a record number of states, 27 in all (including Indiana, Michigan and South Carolina), had federal loans in 2009. States having unpaid balances in 2011 are subject to the FUTA credit reduction.

In 2010, six additional states took federal UI loans: Arizona, Colorado, Delaware, Hawaii, Kansas and Vermont. The potential of FUTA credit reduction will apply in 2012, payable no later than January 31, 2013.

Because most of the federal loans were taken in 2009, tax year 2011 will be the first year that a significant number of employers may realize an increase in their FUTA taxes as a result of the loss in the FUTA credit.

There are currently no states added to the list of borrowers in 2011. Maryland, Massachusetts, New Hampshire, South Dakota, Tennessee and Texas, for instance, repaid their federal loan balances by December 31, 2010.

Because most of the federal loans were taken in 2009, tax year 2011 will be the first year that a significant number of employers may realize an increase in their FUTA taxes as a result of the loss in the FUTA credit. As of June 23, 2011, a staggering 24 states continued to carry a federal UI loan balance from 2009. If these loan balances are not paid off by November 10, 2011, a FUTA credit reduction will apply in the states shown in yellow in the chart on page 6.

**The FUTA credit reduction outlook for 2012 and beyond.** As of June 23, 2011, the overall UI federal loan balance had increased by more than 1.5%. Only 13 of the 31 states, or 42%, that had taken federal UI loans had paid down those loans in 2011. The remaining states, or 58%, either paid nothing toward their loan balance or had increased their borrowing. Based on these 2011 statistics and absent federal legislation, it is projected that a large number of states will continue to have loan balances for the next three to five years, with FUTA credit reductions applicable to employers in those states.

**Pending legislation with favorable impact on the FUTA credit reduction.** H.R. 1745, (JOBS Act of 2011), a Republican-sponsored bill, was introduced in early May 2011, reported favorably out of the House Committee on Ways & Means and ordered placed on the House calendar on May 23, 2011. According to the Congressional Budget Office Cost Estimate, the legislation would provide distribution to the states in 2011 and 2012 of the remaining \$31 billion in temporary federal unemployment funds, which states could at their option use to continue to provide emergency unemployment compensation (EUC) and extended benefits (EB) (as those programs existed on May 1, 2011), reduce employer SUI taxes, or pay for other unemployment-related expenses, including any interest or principal due on federal UI loans.

### Ernst & Young LLP observation

Although a state may discharge its federal UI loan balance, employers in that state may nonetheless be faced with an increase in their UI tax costs depending on how the loan repayment is financed. For instance, Texas issued bonds to repay its federal loan balance, and a surcharge was added to the 2011 SUI tax rates for the repayment of those bonds.

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## State detail of federal UI loan balances as of June 23, 2011

State	Original date of federal UI loan	June 23, 2011 loan balance	January 5, 2011 loan balance	Year FUTA credit reduction applies	June 23, 2011, balance change	% of change June 23 to January 5, 2011
Alabama	Sep 2009	\$44,708,104.03	\$210,388,753.11	2011	(\$165,680,649.08)	-78.75%
Arizona	March 2010	\$230,125,904.66	\$246,901,154.28	2012	(\$16,775,249.62)	-6.79%
Arkansas	March 2009	\$359,989,601.53	\$330,853,383.31	2011	\$29,136,218.22	8.81%
California	January 2009	\$10,957,982,217.09	\$9,521,509,275.25	2011	\$1,436,472,941.84	15.09%
Colorado	January 2010	\$291,459,884.58	\$435,067,503.01	2012	(\$143,607,618.43)	-33.01%
Connecticut	October 2009	\$809,875,582.98	\$538,731,705.05	2011	\$271,143,877.93	50.33%
Delaware	March 2010	\$62,523,367.88	\$34,221,279.28	2012	\$28,302,088.60	82.70%
Florida	August 2009	\$1,540,300,000.00	\$1,981,500,000.00	2011	(\$441,200,000.00)	-22.27%
Georgia	December 2009	\$728,000,000.00	\$544,500,000.00	2011	\$183,500,000.00	33.70%
Hawaii	December 2010	\$13,572,071.77	\$20,129,922.21	2012	(\$6,557,850.44)	-32.58%
Idaho	June 2009	\$202,401,700.22	\$202,401,700.22	2011	\$0.00	0.00%
Illinois	July 2009	\$2,098,011,539.49	\$2,417,585,517.37	2011	(\$319,573,977.88)	-13.22%
Indiana	December 2008	\$1,853,896,789.44	\$1,973,361,211.04	2010	(\$119,464,421.60)	-6.05%
Kansas	March 2010	\$170,821,412.91	\$88,159,421.40	2012	\$82,661,991.51	93.76%
Kentucky	January 2009	\$948,700,000.00	\$810,500,000.00	2011	\$138,200,000.00	17.05%
Massachusetts	January 2011	\$0	\$17,894,206.15	2013	(\$17,894,206.15)	-100.00%
Michigan	September 2006 (defaulted in 2007)	\$3,207,483,491.46	\$3,710,391,759.10	2009	(\$502,908,267.64)	-13.55%
Minnesota	July 2009	\$449,927,008.63	\$564,878,694.71	2011	(\$114,951,686.08)	-20.35%
Missouri	February 2009	\$682,366,668.39	\$733,087,323.86	2011	(\$50,720,655.47)	-6.92%
Nevada	October 2009	\$773,160,968.50	\$632,854,461.90	2011	\$140,306,506.60	22.17%
New Jersey	March 2009	\$1,501,083,528.69	\$1,631,560,930.14	2011	(\$130,477,401.45)	-8.00%
New York	January 2009	\$2,759,622,598.90	\$3,196,382,352.44	2011	(\$436,759,753.54)	-13.66%
North Carolina	February 2009	\$2,510,530,779.65	\$2,532,573,667.93	2011	(\$22,042,888.28)	-0.87%
Ohio	January 2009	\$2,611,387,131.00	\$2,314,186,799.00	2011	\$297,200,332.00	12.84%
Pennsylvania	March 2009	\$3,761,835,374.73	\$3,059,266,784.51	2011	\$702,568,590.22	22.97%
Rhode Island	March 2009	\$218,196,156.60	\$225,472,937.00	2011	(\$7,276,780.40)	-3.23%
South Carolina	December 2008	\$967,068,242.37	\$893,471,757.42	2010	\$73,596,484.95	8.24%
Vermont	March 2010	\$77,731,860.63	\$40,606,498.32	2012	\$37,125,362.31	91.43%
Virgin Islands	August 2009	\$22,569,786.96	\$17,388,847.04	2011	\$5,180,939.92	29.79%
Virginia	October 2009	\$171,570,000.00	\$357,572,000.00	2011	(\$186,002,000.00)	-52.02%
Wisconsin	February 2009	\$1,307,427,214.24	\$1,407,930,812.59	2011	(\$100,503,598.35)	-7.14%
<b>Total</b>		<b>\$41,334,328,987.33</b>	<b>\$40,691,330,657.64</b>		<b>\$642,998,329.60</b>	<b>1.58%</b>

■ States which will realize an increase in FUTA taxes as a result of the loss in FUTA credit if loan balances are not paid off by November 10, 2011.

Because the Federal Unemployment Insurance Tax Act prohibits the states from using UI trust funds to make their interest payments, a significant number of states collect some or all of this payment through employer SUI interest surcharges.

## A matter of interest concerning federal UI loans

The Social Security Act provides that interest on federal UI loan balances accrues daily from October 1 to September 30 (January 1 to September 30 for 2011, since interest was waived under the ARRA for 2010). States are generally required to make their federal interest payments by September 30. Because the Federal Unemployment Insurance Tax Act prohibits the states from using UI trust funds to make their interest payments, a significant number of states collect some or all of this payment through employer SUI interest surcharges.

The issue of paying interest was delayed temporarily under the ARRA, which provided that interest would be waived on federal UI loans for 2009 and 2010. Hence, the interest issue for most states did not surface until this year. Prior to 2011, a few states had already adopted legislation allowing for an interest surcharge trigger under these circumstances. Arkansas law, for instance, provided for a 0.2% advance interest tax that triggers on the quarter following the quarter in which a federal UI loan becomes interest-bearing. For the majority of the states, however, policy-makers have been under the gun to determine how to finance the interest debt before the payment comes due on September 30. As of July 15, 2011, 16 states have already made provisions to collect some or all of the interest payment through employer SUI surcharges, and several states are continuing to investigate the possibility. Ohio, for instance, is giving consideration to an employer SUI interest surcharge to be implemented, perhaps, in 2012.

**Pending legislation to extend waiver of interest on federal UI loans.** An extension of ARRA's waiver of interest on federal UI loans looks promising, with both sides of the House having introduced legislation this year to extend the provision (H.R. 650, S. 286 and H.R. 1745 – the Republican-sponsored JOBS Act).

## Reduction in unemployment benefits

One of the more controversial methods for bringing UI trust funds back into balance this year has been the move on the part of some state lawmakers to slash workers' UI benefits. Michigan was the first to enact such legislation in March of this year, reducing the number of weeks claimants may collect SUI benefits from the standard 26 weeks to 20 weeks, a provision mirrored by Missouri and South Carolina later in the year. Arkansas and Illinois were milder in their benefit cuts this year, reducing the number of weeks of SUI benefits from 26 to 25 weeks.

The latest of the states to enact such legislation, Florida, took a unique approach in reducing UI benefits. For all claims filed on or after January 1, 2012, the duration of benefits adjusts from the current maximum of 26 weeks to a range of 12 to 23 weeks, based upon the average unemployment rate in Florida for the third calendar quarter of the previous year (for example, the maximum number of weeks for 2012 will be based on the average unemployment rate in Florida for July-September 2011). Florida law creates a sliding scale for benefits beginning in 2012 by correlating the maximum weeks of benefits available with the rate of unemployment. The maximum amount of benefits available is 23 weeks when the unemployment rate is 10.5% or greater, *and this scales down to 12 weeks of benefits when the unemployment rate is 5.0% or less.* A week of UI benefits would be added for every 0.5% the average unemployment rate climbs. This change is projected to save the Florida UI trust fund an estimated \$103 million annually. (*HB 7005, Ch. 2011-235, signed by the governor on June 27, 2011; Florida Agency for Workforce Innovation website, June 27, 2011.*)

## Ernst & Young LLP insights

Reducing a claimant's benefits not only reduces the SUI cost to the state, but it could also reduce an employer's SUI tax rate because SUI rates are in part tied to the total benefits charged to an employer's account. For this reason, it is important that changes in law concerning UI benefits also be considered in the SUI cost projection analysis.

## Hikes in the SUI wage bases or rates

There are two general ways to improve UI trust fund balances: decrease the outflow (reduce UI benefits) or increase the inflow – that is, increase the SUI tax rates or the taxable wage base. There has been a flurry of state legislative activity this year to make adjustments in SUI tax rates that more accurately correspond to the financial condition of trust funds; however, it is important to note one state in particular for its unprecedented approach to generating additional SUI revenues. Contained in Rhode Island's FY 2012 budget bill recently signed into law is a provision that, in addition to an increase in the state's SUI wage base beginning in calendar year 2012, provides that for negative-balanced employers with a reserve ratio of negative 24% or less, the SUI wage base will be \$1,500 more than for other employers. (*HB 5894, signed by the governor on June 30, 2011.*)

For the next several years, unemployment cost forecasting will be complicated by a number of factors tied to the recession and post-recession recovery of SUI trust funds.



## Accurately forecasting SUI costs

For the next several years, unemployment cost forecasting will be complicated by a number of factors tied to the recession and post-recession recovery of SUI trust funds. Knowing the pieces of the UI budget puzzle is key in avoiding financial statement surprises. The following table recaps the factors that will influence employer SUI costs in 2011 and beyond.

SUI cost element	Forecasting method
Federal credit reduction	Pinpoint the origination date of the UI loan and identify the current loan balance to project the total FUTA increase that will result from the projected loss in the FUTA credit
Federal UI loan interest	Track state legislation to determine if, when and how a UI interest surcharge will apply
Federal loan payoff	Understand how the state has discharged its federal UI loan balance and if the payoff will affect employer SUI taxes
SUI tax rate schedule changes or wage base increases	Track state legislation to determine changes that may have been made in the SUI tax rate schedules or wage base
UI benefit changes	Track state changes in the UI benefit provisions so that the current rules are used in estimating employer SUI account charges

## Ernst & Young LLP offers assistance in SUI rate forecasting and analysis

Ernst & Young LLP assists businesses in their SUI cost forecasting in the following ways:

- ▶ **Essential SUI facts.** This report, updated quarterly, provides current state research concerning:
  - SUI wage bases
  - SUI tax rate ranges
  - SUI special assessments
  - SUI interest surcharges
  - Voluntary contribution and joint account election deadlines
  - Federal UI loan origination dates and balances
  - Year FUTA credit reduction will first apply
- ▶ **SUI rate analysis and forecasting.** Our Employment Tax Advisory Services team can provide a detailed review of the accuracy of the currently assigned SUI rates based on historical wage and claim data and other pertinent factors. Future SUI rates are projected based on the latest SUI law and regulations and various forecasting models. Services include costs savings that may be obtained through statutory elections (voluntary contributions and joint accounts).

For more information concerning SUI rate projections and analysis, contact an Ernst & Young LLP Employment Tax Advisory Services team member listed on the back cover of this document.



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