SBLC WEEKLY

June 20, 2011 Volume XIII, Issue 24

PAYROLL TAXES

Lots of talk about payroll taxes in Washington. It is hard to keep your FICA separated from your FUTA. There are conversations about both. Before going into the issues, here is the quick refresher on the taxes themselves.

When you spell it out, the FUTA tax gives itself away. The Federal Unemployment Tax Act tax deals with unemployment. Only the employer pays it. The nation's unemployment compensation (UC) system is a federal-state partnership. Federal law sets the framework. The federal tax law, the FUTA is used to collect taxes to fund the federal and states' administrative costs, half of "regular*"extended benefits (EB), and to fund a loan program for the states, if they do not collect enough revenues to cover the costs of the benefits they provide in their states.

The federal FUTA tax rate is 6.2 percent of taxable wages. (The tax rate is composed of a permanent tax rate of 6 percent and a temporary surtax rate of 0.2, more on that later) The taxable wage base is the first $7,000 paid in wages to each employee during a calendar year. Employers who pay the state unemployment tax on a timely basis, receive an offset credit of up to 5.4 percent regardless of the rate of tax they pay the state. Therefore, the net FUTA tax rate is generally 0.8 percent (6.2 percent - 5.4 percent), for a maximum FUTA tax of $56.00 per employee, per year (.008 X $7,000. = $56.00). The FUTA tax is paid on an annual basis and the reporting form is Form 940.

The Federal Insurance Contributions Act (FICA) is actually two taxes. FICA is comprised of Social Security (6.2 percent) and Medicare (1.45 percent) taxes. You will see the acronyms OASDI (Old-Age, Survivors, and Disability Insurance) for the social security portion and HI (Hospital Insurance) used for the Medicare portion. Employers are required to withhold 7.65 percent for FICA from gross compensation of employees. However, there is an annual income cap for the social security portion. It is $106,800 for 2011. In addition to the FICA withheld from the employee, the employer is required to "match" the FICA withholding. Therefore, the employee and employer contribution for FICA taxes is 15.3 percent of compensation. The self-employed also pay into Social Security and Medicare funds at the combined rate of the employee and employer. The FICA tax for the self-employed is called the "self-employment tax" (Officially, the Self Employed Contributions Act (SECA) tax). The self-employment tax is computed at the same rates (15.3 percent) as employee/employer FICA, and is subject to the same annual limits.

Currently, employees are enjoying a "holiday" from a portion of the social security tax part of FICA thanks to the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, TRUIRJCA, enacted at the end of 2010. *The holiday ends at the end of 2011 and its extension is mostly likely what the President is touting.* TRUIRJCA provides a payroll/self-employment tax holiday during 2011 of two percentage points. This means employees pay only 4.2 percent on wages and self-employment individuals pay only 10.4 percent on self-employment income. Since it is a holiday from the social security portion of the tax, it is limited to the income below the cap.

Also, as a result of the enactment of the Hiring Incentives To Restore Employment Act (HIRE ACT), employers that hired unemployed workers after February 3, 2010, and before January 1, 2011 qualified for a 6.2-percent payroll tax "forgiveness" of the employer's share of social security tax on wages paid to these workers in 2010. Employers were still liable for the Medicare portion of the tax. Employers still withheld the employee's 6.2-percent share of Social Security taxes. *While it has come and gone, HIRE also comes up in current conversations. More on that later.*

CURRENT ISSUES

Let's look at the current issue regarding the FUTA. The 0.2 surtax was passed in 1976 on a temporary basis to make up a deficit in the unemployment

insurance trust fund. It was supposed to expire in 1987. The deficit was paid off but every time Congress needs some revenue for something else, it extends the surtax. It has done so six times! The last time in 2009, to pay for the unemployment benefit extension, the surtax was extended until June 30, 2011. So what we have is a likely non-action. Republican tax writers have said they plan to let the surtax expire. The President in his fiscal year 2012 budget proposal called for a permanent extension. However, given his talk of late about payroll tax relief it might be difficult for him to hold on to that stance. Besides, there is really nothing he can do about it. I might note about 30 states have a separate unemployment compensation problem of their own. They owe the federal government payment on unemployment compensation payment loan. Since the federal FUTA tax only is used for federal purposes, none of those tax dollars go to solving the States' problem. More on that later.

Putting aside the FUTA surtax expiration, why is payroll relief in the news? The President raised the issue as the group of bi-partisan legislators meeting with Vice President Biden continues to work towards a deal to allow for an increase in the debt ceiling. This group is not to be confused with the so called "gang of six" senators who were working on a long term deficit reduction deal. (The gang of six is now actually a pack of five as Senator Tom Coburn (R-OK) has taken a time out.) And yes, the Biden group involves the Democrats putting pressure on the Republicans to raise taxes (more accurately to eliminate some tax "expenditures;" what some would call tax breaks or loopholes (e.g. ethanol tax credit)). So yes, it hard to figure how cutting taxes gets thrown into the mix, but it has been. It sounds like the extension of the current temporary 2 percent reduction for employees in the social security tax is what the President has in mind, but at times a revival of the HIRE break for employers gets some attention. Since "logical," Mr. Spock, has never been a prerequisite for Washington, while I think it unlikely, it would not surprise me if the debt ceiling increase deal includes some tax relief. The debt ceiling has been technically reached but as a practical matter the Treasury has indicated that its options for "finessing it" run out in early August. The Biden group has a goal of securing a deal before the July 4th recess. Who knows? The bottom line is you can read the term payroll tax relief in the general media and it can be code for the FICA "holiday" or the HIRE relief revival or a random reference to the FUTA surtax expiration.

STATE UNEMPLOYMENT COMPENSATION PROBLEM

While I am on a roll, here's the refresher on the States' problem. The States have not been able to cover their cost of providing unemployment benefits through the state unemployment tax. So they have turned to the federal government loan program. And several of them owe big time. This has had a cascading impact on employers in those states.

States assess their own payroll taxes on employers to fund regular UC benefits and the state share (half) of the "regular*" EB program. These state UC tax rates are "experience-rated," in which employers generating the fewest claimants have the lowest rates. The state unemployment tax rate on an employer is, in most states, based on the amount of UC paid to former employees. Generally, in most states, the more UC benefits paid to its former employees, the higher the tax rate of the employer, up to a maximum established by state law.

(*The most recent rounds of extensions of unemployment benefits were fully funded by the federal government (or as I prefer to think of it, by all of us as taxpayers.) so they are not the "regular" extended benefits. While the recent extensions might have some impact on the state of the states' unemployment funds, they are probably not major contributors to the states' situation.)

The states have to have a minimum wage base of at least equal to the FUTA wage base. Forty-six states have adopted for the collection of their unemployment funds, a higher taxable wage base than the $7,000 now provided in FUTA for federal tax purposes. For 2010, Washington's taxable wage base was the highest at $36,800. As to state rates, for the latest year available (2009), the preliminary estimated U.S. average tax rate was 0.6 percent of total wages, ranging from a high of 1.3 percent in Rhode Island (taxable wage base of $18,000) to a low of 0.08 percent in the Virgin Islands (taxable wage base of $22,100).

As noted, the federal FUTA tax rate is 6.2 percent of taxable wages. The taxable wage base is the first $7,000 paid in wages to each employee during a calendar year. Employers who pay the state unemployment tax on a timely basis, receive an offset credit of up to 5.4 percent regardless of the rate of tax they pay the state. Therefore, the net FUTA tax rate is generally 0.8 percent (6.2 percent - 5.4 percent), for a maximum FUTA tax of $56.00 per employee, per year (.008 X $7,000. = $56.00). FUTA is paid on an annual basis and the reporting form is Form 940.

Some employers in certain states will say, "Hey, I am not getting that full federal credit." The credit against the federal tax may be reduced if the state has an outstanding loan from the federal government to cover its unemployment benefit shortfalls, To assure that these loans are repaid, federal law provides that when a state has an outstanding loan balance on January 1 for two consecutive years, the full amount of the loan must be repaid before November 10 of the second year or the credit available to employers will be reduced until the loan is repaid. (There will be more about these loans below.) The 5.4 percent credit is reduced in successive increments of a minimum 0.3 percent

for each year in which a loan or loans remain unpaid (reducing the overall credit from 5.4 to 5.1, to 4.8, to 4.5 percent, etc.). Additional offset credit reductions may apply to a state beginning with the third and fifth taxable years if a loan balance is still outstanding and certain criteria are not met.

So this gets us to the "loans" and the current problems the states are encountering.

States have been dipping into the federal loan fund to cover their unemployment benefits at a rapid rate. Recent outstanding balances (three commas are billions!) are:

State	Balance
Alabama	$36,757,247.76
Arizona	$220,677,124.61
Arkansas	$359,989,601.53
California	$10,957,982,217.09
Colorado	$276,114,607.94
Connecticut	$809,875,582.98
Delaware	$62,523,367.88
Florida	$1,516,200,000.00
Georgia	$728,000,000.00
Hawaii	$7,732,795.83
Idaho	$202,401,700.22
Illinois	$2,034,510,815.23
Indiana	$1,839,847,596.42
Kansas	$170,821,412.91
Kentucky	$948,700,000.00
Michigan	$3,194,331,891.39
Minnesota	$429,438,285.89
Missouri	$672,406,218.09
Nevada	$773,160,968.50
New Jersey	$1,436,437,604.16
New York	$2,670,546,411.05
North Carolina	$2,487,427,394.07
Ohio	$2,611,387,131.00
Pennsylvania	$3,761,835,374.73
Rhode Island	$214,021,998.24
South Carolina	$968,343,725.73
Vermont	$77,731,860.63
Virgin Islands	$22,364,530.53
Virginia	$152,640,000.00
Wisconsin	$1,294,726,246.79

This adds up to over $40 billion and the U.S. Department of Labor projects this will increase to $65 billion by 2013. For employers, the important fact to remember is that an outstanding loan balance triggers a reduction in the offset credit applied to the FUTA liability for employers in that state.

The states also owe interest on the loans that is not covered by the funds raised by the reduction in the offset credit. There is also a penalty. A state will lose all offset credit (5.4 percent) for any year in which all interest due under law is not paid by the date on which such interest is required to be paid. The state would also lose all grants for costs of administration until interest due has been paid.

Michigan, Indiana and South Carolina have already triggered the employer's reduction in the offset credit applied to FUTA liability. The rest will soon follow if they do not get their loan balances down. *So there is big problem on the horizon that is independent of the talk about the Federal payroll taxes.*

The President did create a little buzz earlier this year when he offered a suggestion to help the states in his fiscal year 2012 proposed budget but that is not part of the current buzz.

In his proposed budget, the President makes a recommendation for helping the states return to unemployment fund solvency. The President's proposal is to increase the FUTA wage base. This would force the states to raise their wage bases. As noted above, most states already have a higher wage base, so it would have to be pushed high enough to make a difference. The proposal is to increase it to $15,000.
The proposal would also decrease the FUTA tax rate. This is where this gets a little hard to follow. What this means is that the FUTA itself would not raise any additional funds for the federal government for its UC purposes. The idea is to force the states to raise more funds more quickly by raising their bases. So it is not a federal tax increase, but a state tax increase.

The President's budget does call for a deferral of interest and penalty payments due on the states' loans owed to the federal government.