WHITE PAPER

The Unemployment Trickle Effect:

What Small Businesses Need to Know about the Changing Tax Landscape

MAY 2010

TriNet℠
Ambitions realized℠

What is SUI?

- State Unemployment Insurance
- Started with the Social Security Act of 1935, during Great Depression
- All states are required to create unemployment programs providing temporary pay to displaced workers

You can hear the nation's collective sigh of relief as the rate of unemployment slowly declines. Unfortunately, as a result of unemployment rates hitting an all-time high in 2009, we saw changes made to federal and state tax rates, and new regulations introduced attempting to jumpstart the economy and employment. All of this will have an impact on small businesses for years to come.

This white paper will help small business leaders answer the following questions:

- What are the ramifications of new regulations and tax laws?
- How will these changes affect my business?
- What are best practices to control costs as these taxes increase?

Changing Tax Landscape and Ramifications to Small Businesses

Analysts are calling the current economic and tax climate a "perfect storm"–widespread unemployment, changing regulations, new tax reporting requirements and forms, and increasing audits all hitting small businesses at one time. The ramifications of this perfect storm are varied.

New Laws and Regulations

In efforts to promote job growth as the nation's economy continues to recover from recession, the Federal Government is busy finding creative ways to jumpstart hiring. An example is the Hiring Incentives to Restore Employment (HIRE) Act signed into effect in March of 2010. The law includes several major tax provisions designed to spur job growth in the small business sector. The HIRE Act is not the first piece of legislation aimed at triggering growth and hiring to pass through Congress, and it probably won't be the last.

With changing laws and regulations comes new tax reporting requirements, new forms to comply with, and more audits to look forward to. Aside from federal legislation, state and local governments enforce additional regulations and tax reporting requirements on companies. Small business owners must navigate a complex and ever-evolving multi-jurisdictional tax system. Multi-state employers in particular face an increasing burden to remain in compliance and avoid audit red flags.

What is FUTA?

- Federal Unemployment Tax Act
- Pays for state unemployment programs
- Employers are required to pay FUTA taxes on every employee

Unemployment Taxes

For every payroll processed, there exists employment tax reporting obligations for companies big and small. The Social Security Act of 1935 required all states to put in place unemployment programs to provide temporary pay to displaced employees through State Unemployment Insurance (SUI). In difficult economic times, these benefits are a lifeline allowing displaced employees to continue to provide for their families while seeking new employment. In order to fund SUI coffers, companies doing business in the United States pay both federal and state taxes on the wages paid to every employee on their payroll.

The Federal Unemployment Tax Act created an additional payroll tax (FUTA) that pays for the administration of state unemployment programs. It is generally assessed on the employer at a rate of 0.8% on the first $7,000 of wages paid to each employee. State Unemployment Tax (SUTA) is a payroll tax assessed by each individual state that funds the payment of unemployment benefits to employees who are involuntarily terminated by their employer. The amount of wages on which SUTA is assessed varies from state to state.

Assessing State Unemployment Tax Rates

Three factors determine how much an employer will pay in unemployment taxes (with variations from state to state):

- TAXABLE WAGES: FUTA and SUTA are assessed each calendar year on the wages paid to each employee, up to a preset amount. Once an employee's earnings surpass this amount, no additional taxes are paid until the next calendar year. In 2010, the taxable wage base for SUTA varies by state from $7,000 to $36,800. In order to increase revenue, many states are increasing the taxable wage base, resulting in higher taxes.
- ASSIGNED TAX RATE: States assign each employer an unemployment tax rate each year, based in part on the employer's past unemployment benefits payout and taxable wages (also referred to as "experience"). States use rate formulas, similar to income tax brackets, to calculate employer unemployment tax rates. When unemployment is high and the amount of benefits paid out by states increases, the result is higher rates. In 2010, unemployment tax rates in certain states may be as high as 13.5%.

What is SUTA?

- State Unemployment Tax Act
- Payroll taxes paid by employers and assessed by individual states that fund the payment of unemployment benefits
- Assessed by taxable wage base, assigned tax rate and surcharge or additional tax assessment rates

- SURCHARGE OR ADDITIONAL TAX ASSESSMENT RATES: When expected revenue does not meet budgetary requirements, many states will add surcharges in addition to the standard tax to cover the deficit.

Rising State Taxes

As displaced workers collect state unemployment benefits, tax rates assessed on employers generally increase in years two through six – which means the effects from the last year's record high unemployment may be felt by employers for years to come.

The challenging economy has put an immense funding strain on various state and local agencies. Congress has also extended unemployment benefits on several occasions, impacting the states' ability to cover claims. In 2009, nearly 250 legislative items were proposed addressing budgetary concerns and state unemployment funding. States are addressing funding issues through a number of measures including:

- Changing SUTA rate calculation formulas
- Raising the maximum assigned tax rates
- Increasing wage bases retroactively
- Imposing additional assessments over and above standard SUTA rates
- Borrowing Title XII loans

State Borrowing and Implications to Businesses

Unemployment claims are an entitlement and states are legally required to pay these claims, even if they do not have the funds to do so.

When a state's trust fund becomes insufficient to cover expenditures for unemployment compensation benefits, the state unemployment agency becomes "insolvent." States may then borrow from the federal unemployment trust fund to meet their obligations.

As of April 2010, the Department of Labor (DOL) announced thirty-five (35) states are currently insolvent for purposes of unemployment and have borrowed over $41 billion in Title XII loans to pay state unemployment claims. In December 2008, only three (3) states were insolvent. States must pay back Title XII loans within a required period of time–normally within two-and-a-half years. Failure to repay these loans in a timely manner results in a 0.3% increase to FUTA payroll taxes charged to employers each year and a balance is carried forward. A state's failure to repay its loans thus may saddle small businesses with an additional tax burden.

State Unemployment Costs

Is State Unemployment tax controllable?

- **Yes, in part through good employment practices and proper management of unemployment claims**
- **Uncontrollable factors are events that drive up tax rates for all employers.**
- **Example: the economy, extended unemployment benefits, tax avoidance schemes by unscrupulous employers, administrative errors, and states borrowing federal funds to pay unemployment claims**

For 2010 and beyond, employers can expect states to re-fund Trust Fund balances while recouping borrowed funds. In order to raise the additional revenue to make these repayments, many states may implement additional assessments over and above standard SUTA rates. For example, in 2009 Michigan defaulted on its Title XII loan, becoming the first state in the recession to take the 0.3% FUTA supplementary rate. As a result of the defaulted loan, Michigan employers bore an additional tax of $21 per employee in 2009. For 2010, an additional $42 tax per employee is expected.

Best Practices in Navigating Your Small Business Through the Unemployment Trickle Effect

Realistically, there are many uncontrollable factors that drive tax rates upward for all employers including the economy, extended unemployment benefits, tax avoidance schemes by some employers to avoid paying their fair share, administrative errors, and states borrowing federal funds to pay unemployment claims. However, employers can also reduce the rising cost of state unemployment taxes in part through good employment practices and proper claims management.

Controlling Costs

1. *Document everything and keep good records.*
   Make sure "for cause terminations," for which unemployment benefits should not be payable, are well documented. The use of written job descriptions and performance appraisals can help.

2. *Watch out for fraud.*
   According to experts, as much as 10% of all costs in the unemployment insurance system are attributable to fraud. Aside from the risk of intentionally fraudulent claims and activity, surprisingly, many companies unknowingly commit accidental fraud. Employee classification laws, tax reporting procedures, and the like can be confusing and tricky to navigate.

3. *Maintain good hiring and employer practices.*
   Remember that unemployment taxes are assessed on employers per taxable wages for each Social Security Number. This means that tax implications increase due to high turnover.

Payroll & HR-Related Certifications

- **CPP – Certified Payroll Professional**
- **FPC – Fundamental Payroll Certification**
- **PHR® – Professional in Human Resources**
- **SPHR® – Senior Professional in Human Resources**
- **GPHR® – Global Professional in Human Resources**
- **PHR-CA® and SPHR-CA® – PHR and SPHR with state certification in California**

Bringing in outside experts to conduct a full audit of your HR practices can help you control unemployment costs by ensuring the implementation of sound HR practices. For example, implementation of a sound hiring process which includes proper pre-employment screening, onboarding and training, can assist in ensuring that you are bringing quality employees with staying power onto your team. Additionally, a strong employee development program, including performance reviews and ongoing training, will make a large difference in retaining your best talent and minimizing turnover.

A good Professional Employer Organization (PEO) can put HR solutions in place to help streamline and strengthen both your talent acquisition and employee development programs. The shared risk model employed in a PEO relationship ensures that both your small business and your PEO have a vested interest in your employment of a strong and stable team.

Dealing with the Changing Landscape

1. *Know what has changed.*

   Employers should know what the regulations are, what the changes are, and how these changes impact their business. As employers, you will be held accountable for this knowledge or lack thereof. This means you need to read and keep up on what regulations have passed or are pending.

   State agencies send communications and updates often via regular mail – these will be notices or tax returns or employer guides for a particular state (usually given at the beginning of the year). File them and read them!

   If you didn't receive these, or threw them out by accident, go to the website of the individual state agencies and download the guides. Every year these guides change, sometimes even in the middle of the year.

   You can also use additional research tools on employment taxes and regulations, such as CCH / RIA or BNA, which are available via subscription or purchase.

Dealing with the changes:

1. Know what has changed.
2. Get the right help.
3. Join associations.
4. Contact the agencies.
5. Leverage your PEO.

2. *Get the right help.*

Payroll tax administration is complicated – particularly if you operate in more than one state. You need personnel that are trained and experienced in administering payroll tax to ensure compliance. Certified Payroll Professionals (CPP) are credentialed professionals with payroll knowledge and experience. They are familiar with all the regulations, changes and filing requirements, and will be able to advise your business on withholding, and calculation and remittance of federal, state and local payroll taxes.

3. *Join associations.*

For small businesses, it is always good to be part of a professional association like the American Payroll Association, or a local chamber of commerce. Network with other business leaders in the community and learn what your counterparts are saying and doing about specific regulations.

4. *Contact the agencies.*

Call your local or state tax agencies if you have any issues, concerns or need to report something. Remember to always request state agencies to put their responses in writing if you talk to them. State agencies and the federal government hold you accountable for payroll tax errors or omissions even if you were provided the wrong information from the agency verbally or claim ignorance about regulations. Having their opinion or an answer to a question in writing is key in the event of an audit.

5. *Leverage your Professional Employer Organization (PEO).*

If you are a customer of a PEO, they assume responsibility for staying abreast of regulatory and tax issues. Companies following the "do-it-yourself" HR administration model should consider the value provided by PEO organizations, particularly when it comes to staying on top of changing regulations and having the assurance of HR, payroll and benefits expertise that you can leverage for guidance at any time.

About TriNet

TriNet is a Professional Employer Organization (PEO) and serves as a trusted HR partner to small businesses to help contain costs, minimize employer-related risks, relieve administrative burden, and keep focus on core business functions. From routine employee benefits service and payroll processing to high-level human capital consulting, TriNet's PEO expertise is integrated with every facet of a client's organization. Its solutions specialize in serving fast-moving companies in fields such as technology and professional services, who recognize that top-quality employees are the most critical competitive asset.

For more information, please visit **www.trinet.com**

Disclaimer

Copyright © 2010 TriNet. All rights reserved. All trademarks, trade names, service marks and logos referenced herein belong to their respective companies. The content of this white paper has been prepared for educational and information purposes only. The content does not provide legal advice or legal opinions on any specific matters. Transmission of this information is not intended to create, and receipt does not constitute, a lawyer-client relationship between TriNet, the author(s), or the publishers and you. You should not act or refrain from acting on any legal matter based on the content without seeking professional counsel.

TriNet℠
Ambitions realized℠

a0460000015XrAL