

## Conformity Requirements for State UC Laws

### *Experience Rating*

#### **Overview**

UC benefits are primarily financed through the quarterly assessment of taxes on employer payrolls. The tax system is experience rated and operates like an insurance program. An employer begins at an initial rate of tax, which rate will subsequently vary based upon the amount of benefits charged to the employer's account. Thus, the more charges against the account, the higher the tax rate, the fewer claims against the account, the lower the tax rate.

The purposes of experience rating are to ensure an equitable distribution of costs of the system among the employers who cause unemployment, to encourage employers to stabilize their workforce, and to encourage employers to participate in the UC system as charges to their accounts will directly influence their tax rates.

Employers pay a Federal tax, currently 6.2% on the first \$7000 paid with respect to each employee's wages. If a state has a UC law approved by the Secretary of Labor, employers in the state may take two credits against the tax, one for the amount of contributions actually paid into the state unemployment fund, and an additional credit for the difference between the contributions paid and the amount that would have been paid at the highest rate under the system, up to a cap of 5.4%. In order for employers to receive the additional credit, the state law must have an experience rating system conforming to Federal law.

#### **Selected Federal Law Provisions Relating to Experience Rating**

##### **A. Federal Unemployment Tax Act Sections**

§[3303](#)(a)(1) provides that “no reduced rate of contributions to a pooled fund or partially pooled account is permitted to a person (or group of persons) having individuals in his (or their) employ except on the basis of his (or their) experience with respect to unemployment or other factors bearing a direct relation to unemployment risk during not less than the 3 consecutive years immediately preceding the computation date.”

§[3303](#)(a) provides that for “any person (or group of persons) who has (or have) not been subject to the State law for a period of time sufficient to compute the reduced rates permitted by paragraphs (1), (2), and (3) of this subsection on a 3-year basis

- (i) the period of time required may be reduced to the amount of time the person (or group of persons) has (or have) had experience under or has (or have) been subject to the State law, whichever is appropriate, but in no case less than 1 year immediately preceding the computation date, or

(ii) a reduced rate (not less than 1 percent) may be permitted by the State law on a reasonable basis other than as permitted by paragraph (1), (2), or (3).”

§[3303](#)(c)(7) defines computation date as “the date, occurring at least once in each calendar year and within 27 weeks prior to the effective date of new rates of contributions, as of which such rates are computed.”

§[3303](#)(c)(8) provides that a reduced rate is “a rate of contributions lower than the standard rate applicable under the State law, and the term ‘standard rate’ means the rate on the basis of which variations therefrom are computed.”

§[3303](#)(d) provides that “a state law may, without being deemed to violate the standards set forth in subsection (a), permit voluntary contributions to be used in the computation of reduced rates if such contributions are paid prior to the expiration of 120 days after the beginning of the year for which such rates are effective.”

§[3303](#)(e) exempts certain non-profit organizations from the experience rating requirement by providing that “a State may, without being deemed to violate the standards set forth in subsection (a), permit an organization (or group of organizations) described in section 501(c)(3) which is exempt from income tax under section 501(a) to elect (in lieu of paying contributions) to pay into the State unemployment fund amounts equal to the amounts of compensation attributable under the State law to service performed in the employ of such organization (or group).”

§[3309](#)(a)(2) requires states to permit state and local governmental entities, federally recognized Indian tribes and certain non-profit entities to finance benefits through the reimbursement method by providing that “the State law shall provide that a governmental entity, including an Indian tribe, or any other organization (or group of governmental entities or other organizations) which, but for the requirements of this paragraph, would be liable for contributions with respect to service for which paragraph (1) [[3309](#)(a)(1)] applies may elect, for such minimum period and at such time as may be provided by State law, to pay (in lieu of such contributions) into the State unemployment fund amounts equal to the amounts of compensation attributable under the State law to such service. The State law may provide safeguards to ensure that governmental entities or other organizations so electing will make the payments required under such elections.”

## **B. Social Security Act Sections**

### **§[303](#)(k)(1)(A) Mandatory Transfer of Unemployment Experience**

For purposes of subsection (a), the unemployment compensation law of a state must provide –

(A) that if an employer transfers its business to another employer, and both employers are (at the time of transfer) under substantially common ownership, management or control, then the unemployment experience attributable to the transferred business shall also be transferred to (and combined with the unemployment experience attributable to) the employer to whom such business is so transferred.

### **§303(k)(1)(B) Prohibited Transfer of Unemployment Experience**

For purposes of subsection (a), the unemployment compensation law of a state must provide –

(B) that unemployment experience shall not, by virtue of the transfer of a business, be transferred to the person acquiring such business if--

- (i) such person is not otherwise an employer at the time of such acquisition, and
- (ii) the State agency finds that such person acquired the business solely or primarily for the purpose of obtaining a lower rate of contributions.

### **Frequently Asked Questions**

1. What does the Department of Labor mean by the uniform method standard?

All employers must be rated over the same time period using the same factor(s) that bear a direct relation to the employers' experience with unemployment. When this happens, employers with the same experience with respect to unemployment should pay at the same tax rates.

2. What factors are used to measure an employer's unemployment risk?

The Department of Labor long ago said it is not possible to measure "experience with respect to unemployment." Instead, states use factors bearing a direct relation to unemployment risk. The factors that DOL has approved and that are currently in use are:

- Variations in Payroll - A decline (or increase) in an employer's payroll is used as a measure of an employer's risk with respect to unemployment. Benefit payments and separations are not used in calculating an employer's tax rate under this system. Only one state, Alaska, currently uses this experience rating system.
- Reserve Ratio Formula – The earliest and still most common experience rating formula, it is essentially a cost accounting system. On each employer's record is entered the amount of its payroll, its contributions, and the benefits paid to its workers. The benefits are subtracted from the contributions and the resulting balance

is divided by the payroll to determine the size of the balance in terms of the potential liability for benefits inherent in wage payments. Rates are assigned according to a schedule of rates for a specified range of reserve ratios, the higher the ratio, the lower the rate.

- **Benefit Ratio** - The ratio of benefits charged divided by the employer's payroll is the index for rate variation, without taking contributions into account. Rates are assigned according to a tax schedule. This is the second most common experience rating system used by states.
- **Benefit-Wage Ratio** - This system is radically different from the other three experience rating systems. A benefit wage ratio is determined for each employer. The ratio is the total amount of wages that were paid in the base periods of employees who drew benefits over the previous three years divided by the employer's total payroll over the same period. In order to determine an individual employer's rate, the employer's experience factor is multiplied by the state experience factor (the percentage relationship between total benefits paid and total benefit wages in the state during the previous three years.) Only two states, Delaware and Oklahoma, currently use this experience rating system.

### 3. What is SUTA Dumping?

SUTA Dumping is a practice whereby an entity illegally attempts to avoid having its taxes calculated based upon actual experience. It may involve an entity that buys a company with a low experience rating (and thus a lower contribution rate) and fundamentally changes the nature of the acquired business (for example buying a flower shop and turning the business into a construction company.) If the state determines the acquisition was solely or primarily to obtain the lower rate of contributions, the state may assess civil and criminal penalties. Another form of SUTA Dumping occurs when an employer attempts to escape higher taxes by transferring workers to the tax account of another employer with whom it shares substantially common ownership, management or control. State laws require that the experience be transferred when such payroll is transferred. If the employer fails to provide sufficient information to trigger the transfer the experience when it shifts payroll in this manner, both employers may be subject to civil and criminal penalties.

### References

[UIPL No. 1177](#). Provides guidance on the conditions under which employers can recapture experience and alternatives that states can adopt.

[UIPL No. 29-83](#). Extensive discussion of experience rating, including, but not limited to, experience rating systems, principles for charging benefits to an account, non-charging benefits to an account, secondary adjustments, variation measurements.

[UIPL No. 29-83, Change 1](#). Explains the “uniform method” requirement an experience rating system must use to measure employers over the same time using the same factor, or combination of factors, to measure unemployment risk.

[UIPL 29-83, Change 2](#). Identifies “secondary adjustments” and how they relate to experience rating systems.

[UIPL 29-83, Change 3](#). Discusses partial and total transfers of experience and experience rating system requirements.

[UIPL 15-84](#). Explains the concept of the “standard rate” as it relates to experience rating systems, and the requirement that all employers be measured by the same factor(s) over the same period of time.

[UIPL 13-99](#). Explains that an employee’s pre-employment income and other pre-employment circumstances may not be used in experience rating calculations.

[UIPL 30-04](#). Discusses the SUTA Dumping Prevention Act of 2004, including the mandatory and prohibited transfer of experience provisions required.

[UIPL 30-04, Change 1](#). Provides further guidance on when a transfer of experience must be transferred, including a discussion of what constitutes a transfer of trade or business.