Conformity Requirements for State UC Laws

Voluntary Withholding of Income Tax

Background

Section 3304(a)(18), FUTA, requires that "Federal individual income tax from unemployment compensation is to be deducted and withheld if an individual receiving such compensation voluntarily requests such deduction and withholding." States have the option of withholding state and local income taxes if the individual so elects.

This provision was created in 1994 by P.L. 103-465, commonly known as the "GATT" - the General Agreement on Tariffs and Trade. Section 85(a) of the Internal Revenue Code provides that gross income includes UC for purposes of an individual's income tax return. In addition, some states also require UC to be reported as income for state tax purposes. According to the Senate report, Congress created the withholding requirement because "some taxpayers find it burdensome to make quarterly estimated tax payments. These taxpayers may find it more convenient to elect to have Federal taxes withheld at the time specified payments are made to them." (S. Rep. No. 103-412, 103rd Cong. 2d Sess. 137-138 (1994))

Under the GATT, the amount of Federal tax to be withheld was equal to 15% of the gross payment. However, Section 101(c)(7) of the Economic Growth and Tax Relief Reconciliation Act of 2001 reduced the voluntary withholding rate from 15% to 10%. States may not withhold more or less than 10% unless the amount available after mandatory deductions is less than 10% of the gross payment.

Frequently Asked Questions

1. May states require that Federal income tax be withheld from UC benefits?

No. Federal individual income tax may be deducted and withheld only "if an individual receiving such compensation voluntarily requests such deduction and withholding."

2. Where does the withholding of income tax fall in the priorities of deductions from an individual's benefits amount?

Because withholding income tax is voluntary, it must be withheld after all mandatory deductions have been made. Thus, any amounts required to be deducted under state law overpayments and child support intercepts for example) must be withheld prior to withholding any income tax.

3. May the state withhold an amount more or less than 10%?

States may not withhold more or less than 10% unless the amount available after mandatory deductions is less than 10% of the gross payment.

4. May a state require that state income tax be withheld as well as Federal income tax?

Yes. As long as the claimant voluntarily decides to have income taxes withheld, the state may, at its option, require that state income tax also be withheld as a condition of withholding Federal income tax.

References

UIPL 17-95. Discusses voluntary withholding provision and provides draft language.

UIPL 17-95, Change 1. Addresses priority of withholding from UC.

UIPL 32-96. Provides answers to procedural questions for implementing voluntary withholding of Federal income taxes from UC.

UIPL 38-01. Advised states that the voluntary withholding rate on UC benefits was reduced from 15% to 10% for all payments made on or after August 7, 2001.