Understanding Unemployment Insurance

Independent Contractors and Unemployment Compensation

The unemployment compensation (UC) system — also referred to as unemployment insurance (UI) — is designed to temporarily compensate workers who lose their jobs through no fault of their own (as determined by applicable state law). UC is triggered when unemployment was brought about by periods of involuntary termination or periods of economic decline. However, in order to be eligible for benefits, unemployed workers must demonstrate workforce attachment that is usually measured by the individual’s previous amount of wages and weeks of work. Additionally, a jobless worker must be capable and available for work opportunities. Eligibility for unemployment insurance, benefit amounts, and the length of time benefits are available are determined by the laws of the state in which unemployment insurance claims are filed.

Established by the Social Security Act of 1935 (SSA), the UC system is a combined federal-state partnership. Although each state designs its own UC program, the program must be designed within the framework of the federal requirements. As a result, the varying state programs are often quite different and have different impacts on employer profits. Nonetheless, employers who pay UC taxes to a state with unemployment laws in compliance with federal requirement are usually offered tax credits against federal taxes.

If a state law meets minimum federal requirements under the Federal Unemployment Tax Act (FUTA) and Title III of the SSA, both of the following apply:

- Employers receive up to a 5.4 percent basic and additional tax credit against the 6 percent federal unemployment tax.
- The state is entitled to federal grants to cover all necessary costs of administering the UC program.

Note: FUTA, federal, and state income tax rates are subject to changes annually. Employers should consult with the Internal Revenue Service (IRS) or other applicable legal entity for current rates and scheduled changes.

Federal Law

The FUTA imposes a payroll tax on employers based on the wages paid to their employees. All states finance UC primarily through contributions from covered employers on the wages of covered workers. Additionally, three states (Alaska, New Jersey, and Pennsylvania) collect contributions from employees. These taxes are deposited by the state to its account in the Unemployment Trust Fund (UTF) in the Federal Treasury, and are withdrawn as needed to pay benefits.

Covered Employers

The following three tests determine whether an employer must pay FUTA tax. Each test applies to a different category of employee, and each is independent of the others. If a test describes an employer’s situation, the employer is subject to FUTA tax on the wages it pays to employees in that category during the current calendar year. The tests consist of the following:

- General Test
- Household Employees Test
- Farmworkers Test

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