Managing Unemployment Insurance Tax Liability and Lowering Overhead

ABSTRACT: Unemployment insurance tax liabilities have skyrocketed. As a result of the recession, employer-paid UI taxes in 2010 and for the next few years will be significantly higher than in previous years – for some employers tax liabilities have increased by more than 300%. No longer a "nuisance tax," higher UI taxes are having a negative effect on labor costs, cash flow, and profitability. Higher UI taxes are altering hiring and retention decisions and affecting other talent management decisions. Higher UI taxes are increasing employers' interest in effective UI cost control techniques. One technique to measure and allocate an organization's UI taxes liabilities more effectively is internalized experience rating (IER).

SCENARIO: Microbiomic, Inc. develops and sells biomarkers and other specialized microbial based products to the federal government, universities, and the pharmaceutical industry, including a specialized product developed for Placebo Pharmaceuticals, a manufacturer and distributor of proprietary and generic pharmaceuticals and agricultural products. Microbiomic has four facilities in Maryland with the facility in Baltimore dedicated to Microbiomic's contract with Placebo. Employment at the Baltimore facility is cyclical in nature with a period of full production followed by a period of reduced activity – staffing needs are typically reduced by 50%. Currently Microbiomic calculates and allocates annual UI tax liability as a percent of payroll. Question: Is there a more effective technique to recognize and allocate the financial impact of the Placebo contract on Microbiomic's annual UI tax liability?

UI Tax Liabilities: The Basics

Most employers pay two forms of UI taxes: a flat-rated federal UI tax and an experience-rated state UI tax. The federal UI of $56 per employee tax is based on a taxable wage base of $7,000 and a net tax rate of 0.8%.

As noted, the state UI tax is experience-rated and rises and falls each year based on the employer's experience with turnover, UI claims activity, and the amount of benefits collected by separated employees.

> **NOTE**: Under the federal-state UI program, the various states are permitted – within broad standards – to promulgate their own UI financing system. As a result, state UI tax liabilities – as well as benefit entitlement -- varies significantly among the states. For

2010, taxable wage bases range from $7,000 in six states to over $30,000 in five states and state experience-rated tax rates range from 0.0% to more than 15%.

Unemployment insurance cost control begins with a focus on coverage and classification issues. First, the organization should determination whether or not the organization is a “covered employer” under the Federal Unemployment Tax Act (FUTA) and the state UI law – most organizations are. Second, the organization must ensure that it has properly classified employees and independent contractors, that is, the organizations must answer the question: “Were services performed in an employer-employee relationship?” Third, the organization must determine whether or not the services performed by the employees are specifically excluded from the definition of employment under FUTA and state UI law. Fourth, the organization must determine if the wages paid are taxable for FUTA and state purposes.

UI cost control then focuses on experience rating, which is the most effective method of allocating costs, incentivizing employment stabilization, encouraging employer participation in ensuring benefit payment integrity, and holding employers’ accountable for their use of the UI program. Organizations have an opportunity and incentive to use UI cost control activities to reduce their state UI tax liability. One method of improving UI cost control is the use of Internalized Experience Rating.

Internalized Experience Rating: Background

From a management perspective, a cost that is not accurately measured is not effectively managed. From a labor cost accounting perspective, costs that are not properly identified as direct labor costs become overhead. Thus when labor costs are not accurately identified, measured, and properly allocated to the responsible employing unit, department, division, or profit center, cost controls are weak, accountability is lacking, and profitability/loss is miscalculated.

Internalized experience rating addresses these issues by more accurately measuring the impact on profits and losses and by identifying UI management responsibilities. IER is a tool to help management more equitably allocate UI tax liabilities and a process that aids in the preparation of budgets and the calculation of costs, pricing, and profitability.

Further, by more accurately assigning UI tax liabilities, IER exposes UI cost management weaknesses and highlights the advantages of employment stabilization. By more accurately measuring each employing unit’s impact on the organization’s UI tax liability, IER motivates employing units to take action, i.e., to improve their UI cost control activities.

Internalized Experience Rating: Implementation

To help organizations implement internalized experience rating, we have developed a four-step implementation process. This process is built on the foundation of senior management's commitment and support for UI cost management.

Step 1: Analyzing the Applicability of IER

The following activities will help you identify critical issues in implementing IER and help determine IER's applicability for your organization.

> <u>Activity #1: Ask the right questions</u>. Start by asking a series of questions about the organization's strategic and business objections, business risks, key business metrics, organizational structure, talent management goals, and employment stabilization activities. The purposes of this activity are to align UI cost control with organizational objectives and determine the potential ROI from IER.
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> <u>Activity #2: Assess the organization structure</u>. Identify employing units within your employer registration number, either by division, location, profit center, or function. Do these employing units have P&L responsibility? Do these employing units have the authority to make staffing decisions? You should identify the lowest organizational level with P&L and staffing decision making authority.
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> <u>Activity #3: Assess turnover and UI data</u>. Assess turnover, UI claims frequency and severity, changes in employee numbers, and changes in taxable payroll. Are there significant difference in the data among employing units? If yes, your organization will benefit from IER.
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> <u>Activity #4: Assess current perceptions of UI costs</u>. Do individual managers consider UI costs a uniform payroll expense like social security that is allocated proportionally based on size of payroll; or do they consider UI costs an experience-rated tax that reduces profitability? NOTE: the implementation of IER will have a dramatic adverse P&L impact on employing units with high turnover and high benefit charge history. To overcome high-cost units' objections to IER, you may want to hold all units harmless the first year of implementation and use that period to educate the units on UI cost control and help them develop an effect UI cost management program.
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> <u>Activity #5: Determine IER methodology.</u> There are a number of methods to calculate employing units' internal tax rate. The easiest to understand and implement is the ratio of individual employing unit's benefit charges to the total amount of benefit charges. See the example below. A second method is the Benefit Ratio (BR) method. Under this method, the amount of benefit charges for a one-to-three-year period is divided by the taxable payroll for the same period. The resulting ratio is then applied to an internally

developed Tax Allocation Table (TAT) to determine the tax liability for each employing unit. In determining internal UI tax liability, a number of decisions will have to be made: 1) Do you use multiple taxable wage bases that correspond to the taxable wage base used in each state you have employing units or do you use a single enterprise-wide taxable wage base? 2) Do you use multiple TATs that correspond to the tax rates assigned in each state or do you use a single enterprise-wide TAT? 3) If you use a maximum tax rate, how will benefit costs in excess of the maximum be allocated? 4) Should internalized tax liabilities be allocated on a prospective or retrospective basis? 5) How long must new employing units wait before becoming internally experience rated? 6) What internal tax rate should be assigned new employing units? 7) What happens to the experience of employing units that have been sold, closed, or merged into another unit?

Step 2: Collecting Data and Developing UI Metrics

The decisions made in Step 1 provide the foundation for IER. In Step 2, IER objectives and decisions are quantified. At this point you will need to collect IER data, including staffing, retention, and turnover data, UI benefit claim and charge data, taxable payrolls by quarter, and other UI statistics such as UI hearing attendance and decision data, by employing unit.

NOTE: Benefit charge data element by employing unit is critical information. Most states will provide you with a breakout of benefits charges on an employing unit basis. This procedure is referred to as “unit coding.” You should contact the Experience Rating Section of your state UI agency for information regarding the state’s procedure for unit coding.

Specifically, the following data elements will be necessary for your IER system:

<u>Payroll Data</u>:

1) Gross wages by employing unit.
2) Federal taxable wages by employing unit.
3) State taxable wage by employing unit.
4) Severance pay by employing unit.
5) Unemployment insurance taxes by state, by employing unit.
6) W-2 count by employing unit.

<u>Human Resource Data</u>:

1) Number of positions authorized for reporting period by employing unit.
2) Number of employees filling those positions during the reporting period by employing unit.
3) Number, types, and reasons for separation during the reporting period by employing unit.

Unemployment Insurance Claims Data:

1) Number of claims during the period by employing unit.
2) The reasons for separations for these claims by employing unit.
3) Current disposition of all claims filed by employing unit.
4) The benefit year of each claim filed by employing unit.
5) The maximum charges associated with each claim by employing unit. This amount is the product of the claimant's weekly benefit amount (WBA), the maximum duration of each claim, and the employing unit's percent or portion of liability for benefit collected.

Benefit Charge Data:

1) Actual charges, by claimant, by benefit year for the period, by employing unit.
2) Total actual charges for the period by employing unit.
3) Benefit charge adjustments (debits and credits) by claimant, by period, by employing unit.

Step #3: Application of Internalized Experience Rating

In this Step, we apply the data collected in Steps #1 and #2. Continuing the scenario:

Each facility – including the Baltimore facility -- has approximately 100 researchers and production staff. All facilities are reported under a single employer registration number. UI taxes are allocated on a percent of payroll. In 2008 and 2009, Microbiomic had a UI tax rate of 4.5% and an annual tax liability of $180,000. For calendar year 2010, Microbiomic's tax rate increased to 6.4% and has a projected tax liability of $256,000.

Through the use of internalized UI experience rating, Microbiomic seeks to more effectively allocate UI costs, more accurately assign costs to the proper account, and reduce the amount of overhead.

Information:

1) An analysis of work force and turnover data reveals variations in each facility's employment stability.
2) Because of research and product line diversity, each facility is treated as an independent employing unit and reports to a different Vice President. Each facility is treated as a profit center.
3) Historically Microbiomic has treated UI taxes as overhead and has allocated UI taxes as a percent of payroll. A survey of facilities managers has indicated that UI tax liabilities, like workers' compensation and social security, are considered a non-controllable overhead cost.
4) As a part of its enhanced UI cost management activities, Microbiomic has decided to stress the cost and responsibility accounting aspects of internalized experience rating. As a result, individual facilities may be assigned a higher or lower tax rate than is assessed under state law.

Data:
1) Number of facilities = 4
2) 3-year average total payroll = $24,000,000
3) 3-year average taxable payroll = $4,000,000
4) 3-year average benefit charges = $160,000
5) Claimants collect an average of $400/week for a average duration of 8 weeks
6) Assigned tax rate for calendar years 2008 and 2009 = 4.5%
7) Annual tax liability in calendar years 2008 and 2009 = $180,000
8) Assigned tax rate for calendar year 2010 = 6.4%
9) Annual tax liability for calendar year 2010 = $256,000

IER Methodology:
1) Assign each employing unit an internal designation – Column (1)
2) Determine the taxable payroll by employing unit – Column (2)
3) Determine the amount of benefit charges by employing unit – Column (3)
4) Calculate the tax due before IER – Column (4). The taxable payroll for each employing unit is multiplied by the assigned calendar year tax rate for the company. This method assigns individual employing unit tax liability on the basis of the size of payroll, not actual experience with turnover, claims activity, and the amount of benefits charged.
5) Calculate each employing unit's Benefit Charge Factor – Column (5) by dividing each employing unit's amount of benefit charges for the rating period by the Total for the company.
6) Calculate each employing unit's IER UI Tax Liability -- column (6) by multiplying each employing unit's Benefit Charge factor by the company's total tax liability due in Column (4).
7) Determine the difference in the per employing unit tax allocation – Column (7) by subtracting each employing unit's UI Tax Liability – Column (4) by each employing unit's IER UI Tax Liability -- Column (6).
8) Analyze resulting differences and conduct a root cause analysis.
9) Incorporate the IER calculations into your cost accounting and budgeting procedures.
10) Incorporate the IER calculations into your UI cost control management program.

Allocation of UI Tax Liability Before IER

(1)	(2)	(3)	(4)
Facility	3-Year Average Taxable Payroll	3-Year Average Benefit Charges	Each Facility's UI Tax Liability
Rockville	$1,000,000	$ 19,200	$ 64,000
Gaithersburg	$ 900,000	$ 32,000	$ 57,600
Frederick	$1,000,000	$ 38,400	$ 64,000
Baltimore	$1,100,000	$ 48,000	$ 70,400
	$4,000,000	**$137,600**	**$256,000**

Allocation of UI Tax Liability After IER

(1) Facility	(5) Employing Unit Benefit Charges As a % of Total Benefit Charges	(6) Employing Unit IER UI Tax Liability	(7) Difference in per Employing Unit Tax Allocation
Rockville	13.95%	$ 35,718	($28,282)
Gaithersburg	23.25%	$ 59,534	$ 1,934
Fredrick	27.91%	$ 71,448	$ 7,448
Baltimore	34.88%	$ 89,300	$18,900
	100.00%	**$256,000**	

Analysis. Prior to using internalized experience rating, UI tax liabilities for the Baltimore facility were understated by $18,900, while the tax liabilities for the Rockville facility were overstated by $28,282. By using IER, the true financial implications of UI taxes are revealed, the implications of turnover become more obvious, and the value of UI cost management becomes more urgent.

Step 4: Evaluation and Action

With the information developed by internalized experience rating, management now has a clearer understanding and perspective of the strategic, operational, and financial impact of talent management, employment stabilization, turnover, and unemployment insurance costs. This insight will improve management's ability to align talent management, accounting, and UI cost management activities with business objectives, allocate UI cost more accurately, and improve performance management.