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Taxation of Unemployment Benefits

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Taxation of Unemployment Benefits

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Summary

Unemployment compensation (UC) benefits have been fully subject to the federal income tax since the passage of the Tax Reform Act of 1986 (P.L. 99-514). Individuals who receive UC benefits during a year may elect to have the federal (and in some cases state) income tax withheld from their benefits.

Legislation was introduced in the 108th Congress that would have repealed the taxation of UC benefits, provided a two-year suspension of the taxation of UC benefits, or transferred the proceeds from taxing UC benefits to the Unemployment Trust Fund.

This report provides an overview of the taxation of UC benefits and legislation related to taxing UC benefits. This report will be updated as legislative activity warrants.

Overview

Unemployment compensation (UC)¹ benefits are fully subject to the federal income tax. This tax treatment, which has been in place since 1987, puts UC benefits on a par with wages and other ordinary income with regard to income taxation.

In addition to being subject to federal income taxes, UC benefits, as shown in **Table 1**, are taxed by the District of Columbia and 33 of the 40 states with an income tax.² Most other industrial nations also tax unemployment benefits.

¹ In law, this program is called the UC program. However, it is commonly referred to as the UI program, reflecting the social insurance design. For more information regarding the UC program, see CRS Report 94-417, *Unemployment Compensation: A Fact Sheet*, by Celinda Franco, and CRS Report 95-742, *Unemployment Benefits: Legislative Issues in the 108th Congress*, by Celinda Franco.

² While most states tax UC benefits that are subject to federal income taxes, some states exempt Railroad unemployment compensation from state income taxes.

State UC agencies must give benefits claimants the opportunity to elect withholding at the time the claimant first files for UC benefits. Benefits claimants wishing to have federal income tax withheld from their UC benefits must file form W-4V, *Voluntary Withholding Request*. The current withholding rate for federal income tax is 10% of the gross UC benefits payment.

States can also offer UC benefits recipients the option of having state income taxes withheld from their UC benefits. In 2004, as shown in **Table 1**, UC benefits recipients could have state income tax withheld in 17 of the 34 jurisdictions (states and the District of Columbia) that tax UC benefits for tax year 2003.

Table 1. State Personal Income Taxes and State Taxation of UC Benefits in Tax Year 2003; and Withholding on UC Benefits for State Income Taxes in 2004

State	State Income Tax, Tax Year 2003	UC Benefits Taxed at State Level, Tax Year 2003	Withholding on UC Benefits for State Income Tax (Current — 2004)
Alabama	X		
Alaska			
Arkansas	X		
Arizona	X	X	X
California	X		
Colorado	X	X	X
Connecticut	X	X	X
Delaware			
District of Columbia	X	X	
Florida			
Georgia	X	X	X
Hawaii	X	X	
Idaho	X	X	
Illinois	X	X	
Indiana	X	X	
Iowa	X	X	X
Kansas	X	X	X
Kentucky	X	X	
Louisiana	X	X	
Maine	X	X	X
Maryland	X	X	X
Massachusetts	X	X	X
Michigan	X	X	X
Minnesota	X	X	X
Mississippi	X	X	

State	State Income Tax, Tax Year 2003	UC Benefits Taxed at State Level, Tax Year 2003	Withholding on UC Benefits for State Income Tax (Current — 2004)
Missouri	X	X	
Montana	X		
Nebraska	X	X	
Nevada			
New Hampshire			
New Jersey	X		
New Mexico	X	X	
New York	X	X	
North Carolina	X	X	X
North Dakota	X	X	X
Ohio	X	X	
Oklahoma	X	X	X
Oregon	X	X	
Pennsylvania	X		
Rhode Island	X	X	
South Carolina	X	X	
South Dakota			
Tennessee			
Texas			
Utah	X	X	X
Vermont	X	X	X
Virginia	X		
Washington			
West Virginia	X	X	
Wisconsin	X	X	X
Wyoming			

Source: Table prepared by the Congressional Research Service (CRS) from a survey of state websites related to tax year 2003 personal income tax forms and current (2004) unemployment compensation information for claimants.

Impact of Taxing UC Benefits

The following three tables show the latest tax return data related to UC benefits. **Table 2** shows the number of returns with UC benefits and the amount of UC benefits for tax years 1998-2002. The increases for tax years 2001 and 2002 reflect the recent recession, and the policy responses including the extension of UC benefits and providing benefits for individuals impacted by the terrorist attacks and the war in Iraq.

Table 2. Returns With UC Benefits and Amount of UC Benefits, Tax Years 1998-2002

Year	Number of Returns (millions)	Amount (millions)
1998	7.1	\$ 16,777
1999	6.8	\$ 17,649
2000	6.5	\$ 16,982
2001	8.8	\$ 26,891
2002p	10.4	\$ 43,412

Source: Table prepared by the Congressional Research Service (CRS) from data contained in the Internal Revenue Service, *Statistics of Income Bulletins*, various years. Tax year 2002 is preliminary data.

Table 3 shows, for returns with UC benefits in tax year 1999, the ratio of UC benefits to total Adjusted Gross Income by income (AGI) class. As shown in **Table 3**, UC benefits as a share of AGI declines as income (AGI) increases. Overall UC benefits are 7.0% of AGI for all returns with UC benefits in tax year 1999.³

Table 3. UC Benefits as a Share of AGI for Returns With Taxable UC Benefits, Tax Year 1999

Adjusted Gross Income (AGI) Class	UC Benefits as a Share of AGI
Less than \$15,000 ^a	23.0%
\$15,000 less than \$30,000	12.0%
\$30,000 less than \$50,000	7.0%
\$50,000 less than \$100,000	4.0%
\$100,000 less than \$200,000	2.7%
\$200,000 and over	1.1%
Total	7.0%

Source: Table prepared by the Congressional Research Service from the Internal Revenue Service 1999 Public Use SOI File.

a. Includes returns with a gross deficit.

Typically, the loss of a job, even with unemployment benefits, results in a decline in earned income, and often in total income. For some taxpayers with children, the decline in earned income may result in an increase in the earned income credit. For other taxpayers, the decline in earned income may enable the taxpayer to claim the earned income credit.

³ The latest available public use file of tax returns is for tax year 1999.

Legislative History

Before 1979, UC benefits were excluded from income subject to the federal income tax. In the Revenue Act of 1978 (P.L. 95-600), UC benefits were made partially taxable for benefits received after December 31, 1978. Benefits were taxable only for tax filers whose AGI exceeded \$20,000 (single filers) or \$25,000 (joint filers).⁴ Taxation was applied to the lesser of (1) UC benefits or (2) one-half of AGI (with UC benefits included) in excess of the above-mentioned AGI thresholds.⁵

During the 1970s, some policy studies had shown that the proportion of wages replaced by UC benefits on an after-tax basis was large enough to erode seriously a claimant's work incentive.⁶ Taxation of UC benefits served to reduce the degree of after-tax wage replacement and reduce the work disincentive effect. But, taxation's effect was not universal. UC benefits of lower income claimants were left untaxed because their total income was under the tax threshold (i.e., their standard deduction and personal exemptions offset their income).

In 1982, Congress lowered the AGI thresholds for taxation of UC benefits. The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) reduced those thresholds to \$12,000 for single filers, and \$18,000 for joint filers.⁷ A primary motivation of this legislation was to raise revenue, but it left in place a policy of protecting lower income claimants from taxation of UC benefits.⁸

Congress made UC benefits fully taxable in the Tax Reform Act of 1986 (P.L. 99-514), effective for benefits received after December 31, 1986. While this action reversed the original policy of taxing UC benefits only above an AGI threshold, it occurred in the context of a law that removed many low-income filers from the tax rolls, lowered the marginal tax rates for the majority of taxpayers, and expanded eligibility for the earned income credit. The rationale for full taxation of UC benefits was to treat UC benefits the same as wages and to eliminate the work disincentive caused by favorable tax treatment for UC benefits relative to wages.⁹

Concern about claimants' cash flow problems caused by the lack of tax withholding from UC benefits arose during the 1990-1991 recession. P.L. 102-318 required states to

⁴ If the thresholds were adjusted for inflation, the comparable 2004 values would be \$58,128 and \$72,661.

⁵ Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978 (H.R. 13511, 95th Congress, P.L. 95-600)*, Mar. 12, 1979, p. 23.

⁶ For example, see Martin Feldstein, "Unemployment Compensation: Adverse Incentives and Distributional Anomalies," *National Tax Journal*, June 1974.

⁷ If the thresholds were adjusted for inflation, the comparable 2004 values would be \$23,565 and \$35,347.

⁸ Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961, 97th Congress; P.L. 97-248)*, Dec. 31, 1982, pp. 28-29.

⁹ Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; P.L. 99-514)*, JCS-10-87, May 4, 1987, pp. 29-30.

inform all new claimants of their responsibility to pay income tax on UC benefits and to provide them with information on how to file estimated quarterly tax payments. In 1994, P.L. 103-465 required states to withhold federal income tax from UC benefits if a claimant requests withholding, and permitted states to withhold state and local income taxes. P.L. 103-465 set the federal withholding rate at 15% of the gross benefit payment amount. The federal withholding rate was changed to 10% by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) effective August 7, 2001.

Legislation in the 108th Congress

During the 108th Congress, legislation was introduced to repeal the inclusion of UC benefits for tax purposes, or impose a two-year moratorium on the inclusion of UC benefits for tax purposes. Other legislation introduced would have transferred to the state accounts in the Unemployment Trust Fund the tax revenues associated with taxing UC benefits. No action was taken on the legislation introduced in the 108th Congress.