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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). Under tax law, unemployment compensation is a broad category that includes regular state UC benefits, extended benefits (EB), trade adjustment assistance benefits, disaster unemployment assistance, and railroad unemployment benefits, as well as the now expired Emergency Unemployment Compensation (EUC08) benefit.

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. There is no current exclusion on UC benefits for the purposes of federal income tax.

This report provides an overview of the taxation of UC benefits and legislation related to taxing UC benefits.

Contents

Tables

Overview

Unemployment benefits are subject to the federal income tax. This tax treatment, which has been in place since 1987, puts all Unemployment Compensation (UC, as defined by tax law)[1] on an equal basis with wages and other ordinary income with regard to income taxation. Unemployment benefits are not subject to employment taxes, including Social Security and Medicare taxes, because the benefits are not considered to be wages.[2]

In addition to being subject to federal income taxes, in most states that have an income tax, unemployment benefits are taxed.[3] Most other industrial nations also tax unemployment benefits.

State UC agencies must give UC beneficiaries the opportunity to elect federal income tax 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. Federal law does not require that states offer state income tax withholding to UC beneficiaries, although many do offer such services. Beneficiaries may opt to pay quarterly estimated taxes if a state does not offer state income tax withholding.

Impact of Taxing Unemployment Benefits

Table 1 shows the number of federal income tax returns that reported unemployment benefits and the amount of unemployment benefits for tax years 1998 through 2011. The increases in the number of tax returns claiming unemployment benefits as income filed in 2001 through 2003 are attributable to the 2001 economic recession and the policy responses, including the temporary extension of unemployment benefits (the Temporary Emergency Unemployment Compensation program, TEUC) and providing additional benefits for individuals affected by the 2001 terrorist attack.

The most recent recession that began in December 2007 is reflected in the sharp increases in 2008 and 2009 tax returns with an estimated additional 3.7 million tax returns claiming unemployment benefits as income in 2009 as compared with tax filings for 2007. This increase is attributable to higher levels of unemployment as well as the availability of additional weeks of unemployment benefits via the temporary Emergency Unemployment Compensation program (EUC08, P.L. 110-252, as amended).

For tax year 2009, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5 §1007) excluded the first $2,400 from income taxes. Thus, the number of persons who had reportable unemployment insurance income was less than it would have otherwise been. This meant that the

[1] Under tax law, unemployment compensation is a broad category that includes regular state UC benefits, extended benefits (EB), trade adjustment assistance benefits, disaster unemployment assistance, and railroad unemployment benefits. The temporary Emergency Unemployment Compensation (EUC08) benefit is also included within this category.

[2] The federal and state unemployment taxes (FUTA and SUTA) on employers also do not apply to these benefits.

[3] Although most states tax UC benefits, some states exempt the benefits from state income taxes. A few states impose a lowered tax rate on unemployment benefits. Information on a particular state tax treatment of unemployment benefits should be available at the appropriate state tax authority.

amount of unemployment benefits reported as earnings for tax purposes in 2009 was less than it would have otherwise been under the permanent law income tax treatment of unemployment compensation.

The difference in the number of taxpayers reporting UC income in tax year 2010 as compared with 2009 was large, with an additional 3.6 million returns in 2010. The difference in returns was attributable to both the increase of potential weeks of EUC08 benefits available in 2010 (P.L. 111-92, enacted in November 2009) and the termination of the exclusion of the first $2,400 of UC income from income tax calculations.

Nationally, the number of unemployed persons began to decrease in 2011 and as a result this triggered a decrease in the number of weeks available for some extended unemployment benefits (EB and EUC08) as the statues incorporate automatic reduction mechanisms based upon unemployment rates.[4] These reductions in the number of persons receiving benefits and the potential amount of weeks of unemployment benefits are reflected in the decreased number of returns reporting unemployment benefits as well as reported amount.

Table 1. Number of Federal Tax Returns With Reported Unemployment Compensation (UC) and Amount of Benefits, Tax Years 1998-2011

Year	Number of Returns (millions)	Amount (millions of $)
1998	7.1	$16,777
1999	6.8	17,649
2000	6.5	16,982
2001	8.8	26,891
2002	10.3	43,130
2003	10.1	44,008
2004	9.1	32,740
2005	7.9	27,857
2006	7.4	26,524
2007	7.6	29,415
2008	9.5	43,675
2009	11.3	83,538
2010	14.9	120,250
2011	13.2	92,384

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

[4] For details on these programs and their automatic triggers, see CRS Report RL34340, *Extending Unemployment Compensation Benefits During Recessions,* by Julie M. Whittaker and Katelin P. Isaacs

Note: Tax year 2009 does not include the first $2,400 of unemployment benefit income and thus both the number of tax filers and the amount of benefits are understated as compared with years when all unemployment benefits were taxable.

Under *tax* law, "Unemployment Compensation" is broad category that includes regular state UC benefits, extended benefits (EB), trade adjustment assistance benefits, disaster unemployment assistance, and railroad unemployment benefits.

Typically, the loss of a job, even with unemployment benefits, results in a decline in earned income and often in total income. Unemployment benefits are not considered earned income for purposes of computing the earned income tax credit, and the earned income tax credit is not available if adjusted gross income[5] (AGI) exceeds a certain level or if investment income (interest, dividends, and capital gains distributions) exceeds a certain level.[6]

Table 2 shows the most recent Congressional Budget Office (CBO) estimates of the effect of taxing unemployment compensation at various income levels. Families that reported an income of less than $10,000 in 2005 received an estimated $1.8 billion in UC benefits but only paid $6 million in taxes on those benefits. In comparison, families reporting an income between $50,000 and $100,000 received an estimated $7.3 billion in unemployment benefits and paid $1.2 billion in taxes on those benefits.

Table 2. Estimated Effect of Taxing Unemployment Compensation, by Income Class, 2005

Level of Individual or Couple Income[a]	**Recipients of UC** (thousands)	**UC Benefits Affected by Taxation of Benefits** (thousands of $)	**Percentage Affected by Taxation**	**Total UC** (millions of $)	**Total Taxes on Benefits** (millions of $)	**Taxes as a % of Total Benefits**
Less than $10,000	755	82	11	1,829	6	0.3
$10,000 to $15,000	865	344	40	2,608	75	2.9
$15,000 to $20,000	818	382	47	2,799	136	4.9
$20,000 to $25,000	758	408	54	2,643	165	6.3
$25,000 to $30,000	676	388	57	2,391	176	7.4
$30,000 to $40,000	955	664	70	3,540	319	9.0
$40,000 to $50,000	758	634	84	2,825	371	13.1
$50,000 to $100,000	1,944	1,854	95	7,322	1,216	16.6
At least $100,000	536	531	99	2,464	671	27.2

5 The IRS defines AGI as taxable income from all sources including wages, salaries, tips, taxable interest, ordinary dividends, taxable refunds, credits, or offsets of state and local income taxes, alimony received, business income or loss, capital gains or losses, other gains or losses, taxable IRA distributions, taxable pensions and annuities, rental real estate, royalties, farm income or losses, unemployment compensation, taxable social security benefits, and other income minus specific deductions including educator expenses, the IRA deduction, student loan interest deduction, tuition and fees deduction, Archer MSA deduction, moving expenses, one-half of self-employment tax, self-employed health insurance deduction, self-employed SEP, SIMPLE, and qualified plans, penalty on early withdrawal of savings, and alimony paid by the tax payer.

6 For example, for tax year 2013, an adjusted gross income of more than $14,340 would disqualify a single taxpayer with no children; an adjusted gross income of more than $48,378 would disqualify a married couple with two children. Investment income of more than $3,300 would disqualify any taxpayer.

Level of Individual or Couple Income[a]	Recipients of UC (thousands)	UC Benefits Affected by Taxation of Benefits (thousands of $)	Percentage Affected by Taxation	Total UC (millions of $)	Total Taxes on Benefits (millions of $)	Taxes as a % of Total Benefits
All	**8,064**	**5,288**	**66**	**28,423**	**3,135**	**11.0**

Source: Congressional Budget Office (CBO).

a. Income is defined as AGI plus statutory adjustments, tax-exempt interest, and nontaxable social security benefits.

Legislative History

Before 1979, UC benefits were not 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).[7] 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.[8]

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 a claimant's work incentive.[9] Taxation of UC benefits served to reduce the degree of after-tax wage replacement and reduce the work disincentive effect. However, UC benefits of lower-income claimants remained 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.[10] 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.[11]

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. Although 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

[7] If the thresholds were adjusted for inflation, the comparable 2013 values would be $64,175 and $80,219.

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

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

[10] If the thresholds were adjusted for inflation using the All Items Consumer Price Index for All Urban Consumers (CPI-U), the comparable 2013 values would be $28,132 and $42,198.

[11] 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)*, December 31, 1982, pp. 28-29.

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.[12]

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 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 requested 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.

The American Recovery and Reinvestment Act of 2009 (P.L. 111-5 §1007) included a temporary exclusion on the first $2,400 of UC benefits for the purposes of the federal income tax. This exclusion applied only for the 2009 tax year. The Joint Committee on Taxation estimated that this exclusion would reduce federal receipts by approximately $4.7 billion.

At this time, no relevant legislation in the 113th Congress has been introduced.

Acknowledgments

This report was originally written by Christine M. Scott. All inquiries should be directed to the current author listed.

[12] 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.