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Rising Unemployment Costs and 501(c)(3) Nonprofit Strategies

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Overview

Nonprofits have been feeling the effects of the recent recession. Now, with state governments across the nation finding their unemployment funds strained and depleted, all employers will be seeing higher unemployment taxes in the coming years. However, according to federal law, 501(c)(3) organizations have a unique option when it comes to paying their state unemployment tax – and this is something every nonprofit should consider as their tax rates begin to double and triple over the coming years.

Unemployment Tax History

> ***"This is something every nonprofit should consider as their tax rates begin to double and triple over the coming years."***

Unemployment Insurance began as a program instituted in 1936 by Franklin D. Roosevelt as part of the Social Security Act. It was a mechanism to cope with the high rate of unemployment and to help replace lost wages for laid-off workers during the Great Depression. Today, the program is still administered according to state law, and unemployment compensation is financed entirely by employers, not by the state. States tax their employers to build a reserve fund through which laid-off employees can collect benefits.

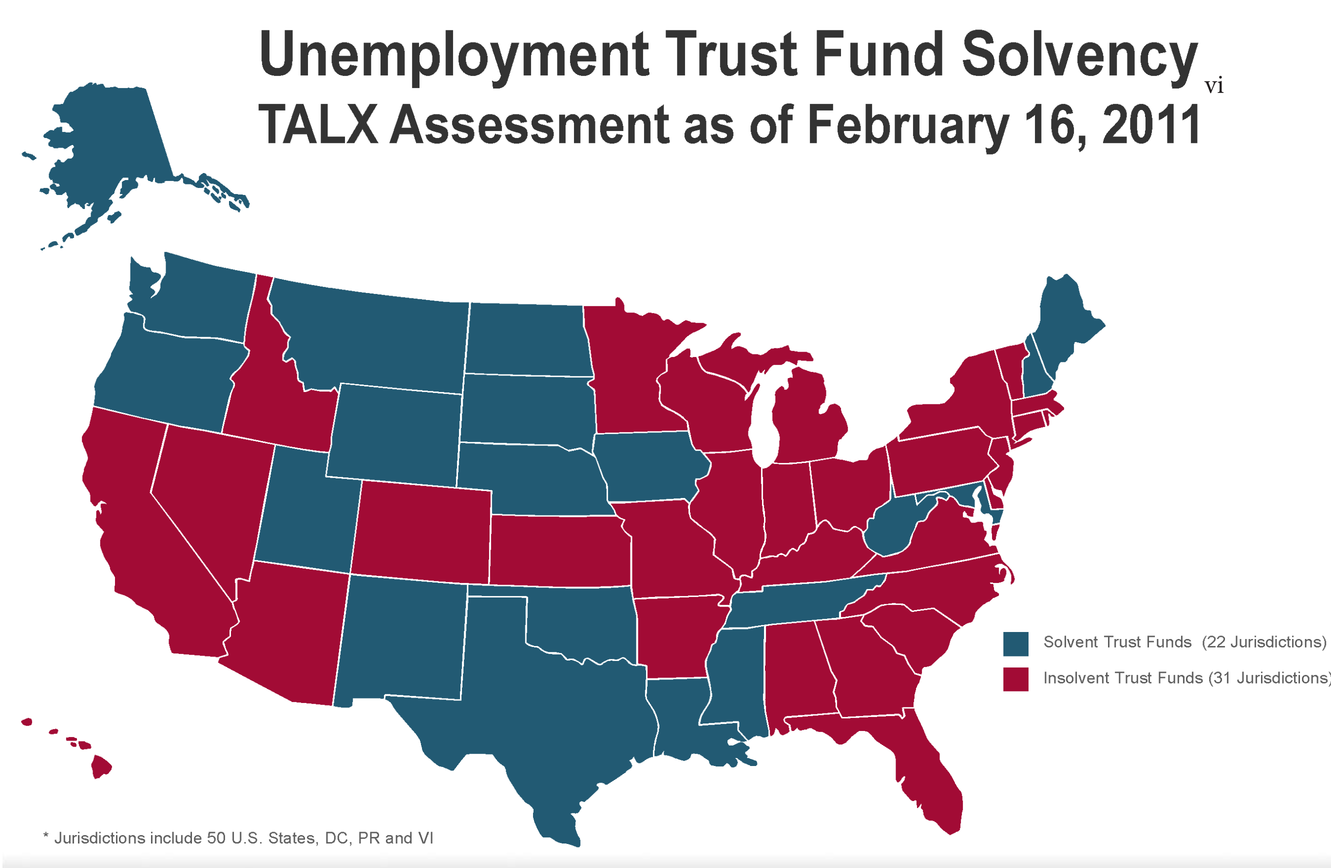
Since its inception, however, the federal-state Unemployment Insurance (UI) program has been plagued with issues. And now with the recent recession and the resulting impact on unemployment, problems like underfunded reserves, federal borrowing, fund insolvency and ballooning UI tax rates are a threat to both the states that control the UI funds and the employers who must pay into them.

Current Threats to Employers

According to a GAO (Government Accountability Office) report on unemployment insurance trust funds released in April 2010, "The recession that began in December 2007 has resulted in the worst labor market conditions in the United States since at least the early 1980s, if not since the Great Depression of the 1930s…unemployment remains very high and has continued to increase in most states, suggesting that state UI programs will continue to face serious financial challenges for at least the near future." [i] And according to Douglas Holmes, President of the Strategic Services on Unemployment & Workers' Compensation (UWC), "It is expected that rates will double or triple over the coming few years, and then remain there for at least a decade or more." [ii]

Due to this heavy strain on unemployment funds, 35 states have borrowed from the federal government, with many of them now insolvent (see map below). In order to pay back these loans, now totaling over $40 billion plus $1.3 billion in interest, most states will be raising either the UI tax rate or the taxable wage base, which both effectively raise the taxes employers pay.[iii] In some cases, employers will see both raised, while employers in more than half the country will also see administrative surcharges being tacked on to their unemployment costs.[iv]

In spite of the rate hikes and Federal borrowing, state UI funds are still at high risk. Even with all of the efforts made to resolve the UI fund issues, many states will be not even be able to recover before the next recession.[v] Because state UI funds have been historically under-funded in high unemployment periods, ultimately employers will bear the burden of making up for the shortfall and the resulting borrowing to cover unemployment fund deficits.



Impact on Nonprofits

As employers, 501(c)(3) organizations face a double threat: Reductions in state and federal funding have coincided with an increased demand for the services that nonprofits provide. The obligation on nonprofits to make every dollar count has never been greater.

Yet nonprofits that attempt to reduce their unemployment expenditures often find that much of this cost appears to be outside their control. Historically high unemployment across many economic sectors and extensive reliance on federal lending have resulted in widespread increases in state unemployment taxes, even for employers who have managed their turnover and claims activity effectively. In other words, the tax rate that nonprofits pay is comprised of not only their state's need to cover federal borrowing, but also the high unemployment claims of other employers.

The high volume of unemployment claims activity being processed by the states—and the increased likelihood of errors and inaccurate charges as a result—also increases the pressure on employers to monitor and protest their claims more effectively. For nonprofits, however, this is often a challenge when most resources are committed to accomplishing the organization's mission and providing needed services.

Alternative for Nonprofits

501(c)(3) organizations have a unique advantage over for-profit employers. According to a federal law enacted in 1970 (Public Law 97-373), nonprofits can elect to become a "reimbursing employer." A reimbursing employer is a nonprofit that pays the state only for its own unemployment claims, dollar-for-dollar, thereby potentially reducing their unemployment costs if their claims experience is lower than what they are paying into the state system.

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For nonprofits with more than 10 FTEs (full-time equivalent employees), this alternative can be very beneficial. However, not only is this option potentially more time consuming and complex, it can put nonprofits in a tenuous position if there are unanticipated spikes in claims, and they do not have the cash flow to cover this immediate cost. In addition, monitoring claims for inaccuracies becomes even more vital, but can be an added strain on human resource capacities. It's important to weigh these factors among others when making the decision to become a reimbursing employer.

Reducing the Risk

One way nonprofits can reduce the risks of claims spikes and administrative burden is by joining an unemployment trust.

An unemployment trust can aid in building a reserve of funds and provide stop-loss protection for unexpected claims, in addition to reducing the burden on human resources by assisting with paperwork and by working with the state on the organization's behalf.

Should You Become a Reimbursing Employer?

You should consider becoming a reimbursing employer if:

- ✓ You are a 501(c)(3) currently paying into the state UI system and want to stop subsidizing the claims of other employers.
- ✓ You have more than 10 full-time employees.
- ✓ You do not foresee large staff cuts in the near future.
- ✓ You have low to moderate unemployment claims on a historical basis.

You should stay in the state UI system if:

- ✓ You are planning a sizeable staff reduction in the next 6-12 months.
- ✓ You are currently, and have been for years, at the top of the state rate scale for unemployment taxes.
- ✓ You have fewer than 10 employees.
- ✓ Your agency has a seasonal staff that regularly collects unemployment benefits.

For those nonprofits thinking about becoming a reimbursing employer, or those who have already become a reimbursing employer on their own, joining an unemployment trust can provide some key benefits and additional cost savings. (Not all trusts operate the same, so make sure to clarify whether the following benefits apply):

1. **Building a reserve** – Through some trusts, you can build a reserve of funds out of which your claims will be paid. Unlike the state unemployment system, this reserve is generally owned by your organization and can be taken with you if you leave. It also provides necessary protection from unexpected claims. A trust can also conservatively invest these reserves in order to help you build your organization's assets.

2. **Reduced Rate** – Because your contributions are based on your own unemployment claims experience, you can pay a lower rate than you would through the state system, while still being protected through the trust. In a trust, liability is typically not pooled, whereas the state system socializes rates to cover companies with higher claims.

3. **Established Contribution Rates** – You can spread claims liability out over the course of the entire year to preserve cash flow when you receive a quarterly rate. This also allows for easier annual budgeting. Because your organization is liable for any claims costs immediately as they occur, reimbursing on your own can mean steep highs and lows depending on claims activity. With a trust, your claims are generally paid out of your account so you usually won't see this kind of volatility.

4. **Stop-Loss Protection** – Trusts will often provide stop-loss protection in the event of a major spike in claims that your account cannot cover. Therefore, your claims will always be covered without concern, and you can later rebuild your account through your deposits.

5. **No Surcharges** – You will not pay state surcharges, unless mandated against all employers in your state regardless of reimbursing status.

6. **Administrative Support** – A quality trust will file the initial paperwork with the state on your organization's behalf, monitor all incoming claims, and provide your staff with the administrative and training support they need to accurately process unemployment claims, thereby reducing the number of claims improperly paid out.

Selecting a Trust

When it comes to joining an unemployment trust, you want to be sure that you are receiving the maximum level of service and experienced fund management, without paying high administrative fees that cut into your savings potential. Following are some questions to ask when evaluating an unemployment trust:

> ✓ How long has the trust been in operation and how many nonprofits are currently members?
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> ✓ What are the administrative expenses and how are they assessed?
>
> ✓ What is the trust's financial history?
>
> ✓ What type of claims monitoring services does the trust provide, if any?
>
> ✓ How are members protected if claims charges increase unexpectedly?

Review of Your Options

1. **Remain in the State UI System** – For some employers, staying in the state unemployment insurance system makes sense. Smaller organizations with fewer than 10 employees may not benefit from becoming a reimbursing employer because the amount they pay annually to their state account is still less than the cost of one unemployment claim. Also, employers who have a consistently high claims experience, or are anticipating layoffs, might also want to stay with the state until they stabilize.

2. **Self Reimburse** – Many nonprofit employers will find that their claims experience is stable enough and their organization is large enough that becoming a reimbursing employer could represent a significant savings. If they truly feel they have the resources and capacity to manage their unemployment claims consistent with best practices and can cover a sudden spike in claims, they may feel comfortable remaining a reimbursing employer on their own.

3. **Join a Trust** – Those employers who would like the safety and convenience of a long-standing unemployment trust should consider finding out if they qualify to join one. Advantages such as building a reserve and protecting the organization from cash flow risk can be especially important to nonprofit boards in the current economic conditions. With state taxes and unemployment rates continuing to be unstable, the protection of a large grantor trust and the support of a professional claims monitor can be of great value.

Find Out More

To learn more about this topic, you can contact one of the experts at the Unemployment Service Trust (UST). Email us at ***info@chooseUST.org*** or call Bill Downey at ***1-888-249-4788 ext. 1156***.

You can also watch a brief three-minute video about nonprofit unemployment costs and solutions at: ***www.chooseUST.org/movie***

[i.] U.S. Government Accountability Office. (2010, April). *GAO-10-440 Unemployment Insurance Trust Funds: Long-standing State Financing Policies Have Increased Risk of Insolvency*. Washington, DC.

[ii] Holmes, Doug. (2010, June). *Presentation given at the Unemployment Services Trust Annual Conference*. Nashville, TN.

[iii] U.S. Government Accountability Office. (2010, April). *GAO-10-440 Unemployment Insurance Trust Funds: Long-standing State Financing Policies Have Increased Risk of Insolvency*. Washington, DC.

[iv] TALX Corporation. (2010, April). *2010 Unemployment Tax Rate Schedule*. Hilliard, OH.

[v] Holmes, Doug. (2010, June). *Presentation given at the Unemployment Services Trust Annual Conference*. Nashville, TN.

[vi] TALX Corporation. (2011, February). *Unemployment Economic Update*. Hilliard, OH.

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