

## UNEMPLOYMENT COMPENSATION

### INSURANCE: Which State Provides The Coverage --- Lived-In or Worked-In State?

For multi-state employees, only one state should provide unemployment compensation insurance coverage for any particular employee. Thus, while an employer may be paying contributions to more than one state on behalf of various employees, employer contributions should be paid only to one state for each of those employees. Importantly, that state is the one which will ultimately pay unemployment compensation benefits if the need arises. While the choice of state depends on the facts of each situation, there are generally only four possible scenarios.

First, the employee may live and work entirely within the same state. This scenario is both the most common and the easiest to resolve. The rule is that the WORKED-IN state provides the unemployment compensation insurance coverage.

In the second scenario, the employee lives in State "A", but works entirely within State "B". Again, the rule is that the WORKED-IN state provides the unemployment compensation insurance coverage. Therefore, the employer's quarterly wage reports and contributions go to State "B".

In the third scenario, the employer transfers the employee's work from State "B" to State "C". When the work is TEMPORARILY transferred from one state to another, the employer should continue to report on behalf of the employee to the state in which the employee normally works and is covered. However, a PERMANENT transfer requires that reports and contributions, beginning from the date of transfer, be made to the new state --- State "C" in our example. For taxable wage purposes, any state (except Minnesota) to which an employee is transferred will allow the employer to count (or "carry forward") wages previously paid to the employee during the same calendar year in the state from which the employee's work was transferred. This assumes that the employer's Federal EIN is unchanged. Thus, the employer does not have to make a duplicate contribution to the second state, repeating the contributions already made.

### What Happens When the Employee WORKS In the Same Pay Period in TWO or More States?

In the fourth scenario, the employee lives in State "A", but works some of the time in State "C" and the remaining time in State "D" (and perhaps in additional states). The point is that there are two or more worked-in states, but since the employer is required to pay contributions to only one state --- which state?

To aid employers with a worker in this situation, the states have agreed on a five-step analysis. The five steps are questions to be answered in a particular order. If the answer to any question is "YES", the coverage state has been determined at that step, and no more of the questions need to be considered.

#### **STEP 1: Is the employee's work "localized" to one state?**

Is the work performed primarily in one state, with only incidental work performed in other states --- in other words, is the work that is performed in the other states of a mere temporary or transitory nature, and consist only of isolated transactions? So, if State "C" is the primary work state and if only isolated transactions or incidental work is performed in State "D," then State "C" is the coverage state. But, if STEP 1 is not a good description of the employee's situation, go to the next step.

#### **STEP 2: Is the employee's "base of operations" in one particular state?**

Is there a state in which the employee performs some services AND reports for duty or starts work or to which he or she customarily returns at the end of the day? The "base of operations" may be a worker's office (which even may be maintained in his or her house), a place specified in the employment contract where the employee receives instructions, a place to which the worker has mail and supplies sent, or where a worker maintains business records. So, if State "D" is the worker's "base of operations" and some work is performed in that state, but more work is performed in State "C," then nevertheless State "D" is the coverage state. However, if neither STEPS 1 or 2 are a good description of the employee's situation, go to the next step.

#### **STEP 3: Does the employee work at least part of the time in the State where the employer's office is located?**

Such a state would be called the "place of control." Is it possible to fix a "place of control" in a particular state in which some of the work is performed? While the "base of operations" refers to a WORKER'S base, the place of direction and control is usually the location from which the EMPLOYER (or its representative) controls or has the right to control the individual's work. It is the place of immediate control rather than the place of ultimate control that is significant. Thus, if State "C" is the location of the employer's national headquarters, State "D" is where the worker's supervisor is located and State "E" is merely another worked-in state, State "D" is the coverage state, even though the worker performs at least some work in each of the three states. If STEPS 1, 2 or 3 have not yet described the worker's factual situation, go to STEP 4.

#### **STEP 4: Does the employee work at least part of the time in the state of the employee's residence?**

If the services are not "localized," and neither the "base of operations" nor the "place of control" is in any state in which some of the worker's services are performed, the proper choice is the state of the employee's residence, provided some of the work is performed in that state.

**STEP 5: If STEPS 1 to 4 do not describe the worker's factual situation,** there may be a provision in the laws of the states where work is performed, or of the state where the employee is resident, that will permit allocation of the worker to a particular state. However, normally the employer finds the solution before reaching STEP 5.

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## HOW THE FICA INCOME TAX CREDIT RE-PAYS RESTAURANT EMPLOYERS

Before 1988, restaurant operators with tipped employees paid Social Security and Medicare (FICA) tax on ONLY those tip amounts deemed to be "wages" since they were being used to support a tip credit. Generally, these employers claimed a tip credit for part of the minimum wage rate they were required to pay. So, if NO tip credit were claimed, there would have been NO FICA tax on the employee's reported tips.

However, effective January 1, 1988, the law was changed to make ALL reported tips subject to FICA tax. The tax was paid by the employee (subject to the taxable wage limit for Social Security tax, but not limited for Medicare tax), and matched by the employer.

In 1993, Congress changed the law again, to reduce the FICA tax burden on employers operating food and beverage establishments ("restaurants"). However, Congress did not simply repeal the employer-paid FICA tax on tips. Instead, an INCOME TAX CREDIT was established to offset the employer's already-paid FICA tax on any reported tips in excess of tips used to support a tip credit. The change became effective for taxes paid after December 31, 1993, and provided potential tax relief for 1994 and in subsequent years.

### How the Employer's FICA Income Tax Credit Works

The Internal Revenue Code already allows business tax credits for various purposes, which reduce Federal income tax liability. The amount of the FICA Income Tax Credit is the employer's FICA tax rate (currently 7.65%) multiplied times any employee-reported tip income which was not used to support tip credit for minimum wage purposes.

For example, under current Federal minimum wage requirements, if an employee is paid a cash wage of \$2.13 per hour, and he or she reports tips of \$6.02 (on average) per hour, the first \$3.02 per hour of reported tips may be considered "wages" to bring the employee to the required Federal minimum wage rate of \$5.15 per hour (\$2.13 cash wage + \$3.02 tip credit = \$5.15). In this example, the remaining \$3.00 per hour of reported tips (\$6.02 - \$3.02) is not considered "wages" under the Fair Labor Standards Act, and the FICA tax paid by the employer on this portion of reported tips is eligible for the FICA Income Tax Credit.

Like other general business tax credits under the Internal Revenue Code, this tax credit is not refundable. An employer must have Federal income tax liability (present, past or future) to use the credit. If there is no Federal income tax liability in a particular year or if the available credits exceed the Federal income tax liability, the unused credit can be carried back one year or forward up to twenty years, to years in which there is a Federal tax liability against which the credit can be applied.

Also, the matching FICA tax payments an employer makes are a business expense deduction against Federal taxable income. To the extent that the employer claims the FICA Income Tax Credit, the employer will not be able to receive a business expense deduction for that amount of FICA tax. However, the value of a tax CREDIT for Federal income tax purposes may be several times the value of the FICA tax as a business expense DEDUCTION.

### Computing the Credit

Importantly, if state minimum wage rate laws were applied when the payroll calculations were made, and the state wage rate and maximum tip credit differ from Federal, then the payroll tip credit must be re-calculated using FEDERAL standards, if the FICA Income Tax Credit is to be calculated correctly. Regardless of how the payroll was calculated, the employer must compute the reported tips which qualify by using Federal minimum wage and tip credit standards --- that is, a minimum wage rate of \$5.15 per hour and maximum tip credit of \$3.02 per hour. Here is an illustration:

**STEP I** -- Assume a cash wage of \$3.00 per hour paid by the employer, totaling \$120 (\$3.00 X 40 hours), and tips reported by the employee of \$320 (\$8.00 tips per hour X 40 hours). Therefore, with total earnings of \$440 (\$120 + \$320), the employer-paid FICA tax is \$33.66 (\$440 X 7.65%).

**STEP II** -- Assume the same cash wages of \$3.00 per hour paid by the employer, or \$120 (\$3.00 X 40 hours), and reported tips used to reach the Federal minimum wage rate (\$5.15), of \$86 (\$5.15 - \$3.00 cash wage = \$2.15 tip credit X 40 hours). Therefore, the "tips deemed wages" (tip credit) under the Fair Labor Standards Act is \$86.

**STEP III** -- The reported tips in EXCESS of "tips deemed wages" is \$234 (using \$5.15 as the Federal minimum wage rate), derived by subtracting "tips deemed wages" (\$86) from total reported tips of \$320.

**STEP IV** -- The amount eligible to be claimed as income tax credit is \$17.90 (\$234 X 7.65%). Potential ANNUAL employer savings from the tipped employee described above would be \$930.80 (\$17.90 X 52 weeks).

The FICA Income Tax Credit is computed the same way whether the employer is an individual, a partnership, an "S" corporation or a "C" corporation. The employer claims the income tax credit by completing Form 8846 (Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips) and attaching it to the annual business income tax return.

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## ARKANSAS, DELAWARE, MAINE AND OHIO INCREASE MINIMUM WAGE RATES

As of 10/1/2006, **Arkansas** will increase the state's minimum wage rate from \$5.15 to \$6.25 per hour. The minimum cash wage for tipped employees will be increased from \$2.58 to \$2.63 per hour. Therefore, the maximum tip credit will increase from \$2.57 to \$3.62 per hour.

Starting 1/1/2007, **Delaware** will make the first of two increases to the state minimum wage rate.

--- effective **1/1/2007**:

the regular rate increases from \$6.15 to \$6.65 per hour, and the minimum cash wage for tipped employees will remain unchanged at \$2.23 per hour. Therefore, the maximum tip credit will increase from \$3.92 to \$4.42 per hour.

--- effective **1/1/2008**:

the regular rate increases from \$6.65 to \$7.15 per hour, and the minimum cash wage for tipped employees will remain unchanged at \$2.23 per hour. Thus, the maximum tip credit will increase from \$4.42 to \$4.92 per hour.

Beginning on 10/1/2006, **Maine** will make the first of two increases to the state minimum wage rate.

--- effective **10/1/2006**:

the regular rate increases from \$6.50 to \$6.75 per hour, and the minimum cash wage for tipped employees will increase from \$3.25 to \$3.38 per hour. Therefore, the maximum tip credit increases from \$3.25 to \$3.37 per hour.

--- effective **10/1/2007**:

the regular rate increases from \$6.75 to \$7.00 per hour, and the minimum cash wage for tipped employees will increase from \$3.38 to \$3.50 per hour. Thus, the maximum tip credit will increase from \$3.37 to \$3.50 per hour.

Historically, **Ohio** has had a three-tiered state minimum wage requirement. Therefore, Ohio has had three state minimum wage rates, depending on the gross annual sales of the employer. The three tiers were defined as employers with sales of \$500,000 or more, employers with sales of \$150,000 but less than \$500,000, and employers with sales of less than \$150,000. Effective 6/30/2006, Ohio replaced the three-tier approach with a single minimum wage rate for all employers, conforming its rates to the Federal Fair Labor Standards Act. Therefore, for all Ohio employers, the regular minimum wage rate will be \$5.15 per hour. For tipped employees, the minimum cash wage rate will be \$2.13 per hour, and the maximum tip credit will be \$3.02 per hour.

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# ADP's Tax Researcher

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(October, 2005 through September, 2006)

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