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UNEMPLOYMENT INSURANCE

Survey of State Administrators and Contacts with Companies Promoting Tax Avoidance Practices

Statement of Robert J. Cramer, Managing Director
Office of Special Investigations

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Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to discuss the results of our investigation of the extent to which states have found that companies manipulate state unemployment tax rates through a variety of methods in order to lower their unemployment taxes, a practice known as "SUTA dumping," and of the extent to which some consulting firms promote SUTA dumping methods.

We conducted our investigation from March 2003 through June 2003 in accordance with quality standards for investigations as set forth by the President's Council on Integrity and Efficiency. To obtain an overview of the extent of the problem, we conducted a survey of unemployment insurance administrators, in the 50 states, the District of Columbia, U.S. Virgin Islands and Puerto Rico. Additionally, one of our agents, posing as a business owner who was looking for ways to reduce state unemployment insurance taxes, placed telephone calls to four consulting firms we identified through the Internet to determine whether they promote SUTA dumping techniques. We also interviewed officials of the Office of Workforce Security, Department of Labor (DOL) to determine how the federal-state unemployment program operates.

I am accompanied today by Special Agent Paul Desaulniers.

In summary, approximately three-fifths of the state unemployment insurance administrators informed us that their state laws are insufficient to combat SUTA dumping and that enforcement efforts to combat such practices are inadequate. Many of the remaining administrators reported that their laws and enforcement efforts are sufficient to address the problem. Other administrators told us that they do not have, or are not aware of, SUTA dumping problems in their states. Additionally, we found that three of the four consulting firms we contacted were willing to assist us in developing SUTA dumping methods for our fictitious business. The fourth firm suggested that SUTA dumping methods are illegal in most states and indicated that they were reluctant to engage in this type of business.

Background

The federal-state unemployment insurance program, created in part by the Social Security Act of 1935, is administered under state law based on federal requirements. The federal government sets broad policy for administration of the program, monitors state performance, and provides technical assistance as necessary to the states. To finance the program,

states collect unemployment insurance taxes from employers to supply the unemployment insurance trust fund. When employers underpay their taxes, states may compensate for these losses by increasing the tax rate for all employers. Therefore, companies that do not manipulate their tax rates by engaging in SUTA dumping practices may be effectively penalized by the SUTA dumping practices of companies that do. Currently, there is no federal mandate requiring states to promulgate laws to restrict employers from engaging in SUTA dumping practices.

States use an "experience rating" system to assign tax rates to a business based on its history of unemployment insurance claims; generally a business with a large number of unemployment claims will have a high experience rating and a correspondingly high tax rate. Employers engage in SUTA dumping when they try to lower the amount of tax they pay by altering their experience ratings. Some employers lower their experience ratings using a variety of methods, which include the following, among others:

- **Purchased shell transactions**. Purchased shell transactions occur when a newly formed company purchases an existing business that has a low experience rating and, therefore, a lower tax rate than the newly formed company would have. Under some state laws dealing with employer succession, the existing business's low experience rating would be transferred to the newly formed company.

- **Affiliated shell transactions**. Affiliated shell transactions occur when an existing business with a high experience rating forms a number of additional corporations, transfers a small number of employees to those corporations, and pays unemployment taxes on their wages until the additional corporations earn a minimum tax rate. Subsequently, major portions of the original company's employees are moved to one or more of the new companies to take advantage of the lower unemployment tax rate, thereby "dumping" the original company's high tax rate.

Survey Results

To obtain an overview of the extent to which these and other SUTA dumping practices are used throughout the United States, we conducted a nationwide survey of state unemployment insurance administrators.[1] More than half of the 50 administrators who responded to our survey acknowledged that SUTA dumping practices are, or may be, resulting in a loss of state unemployment tax revenue. Fourteen states reported that they have identified specific SUTA dumping cases within the past 3 years, with losses from these cases exceeding $120 million. The employee leasing industry-followed by the hospitality and construction industries, respectively-was most often cited by administrators as engaging in SUTA dumping practices.

Administrators in 21 states reported that they have no laws specifically addressing SUTA dumping practices. The remaining 29 state administrators indicated that they have laws addressing SUTA dumping, but 7 of them felt that those laws were inadequate. Approximately two-fifths of the administrators indicated that their states are adequately addressing the problem or that they do not know of any SUTA dumping in their states. Many administrators noted that identifying and proving SUTA dumping is a time-consuming and resource-intensive process. They also cited poor detection methods and inadequate funding for investigation and enforcement efforts as obstacles to addressing these practices.

Administrators in 20 states reported that other state laws, often those dealing with employer succession, adequately address SUTA dumping practices. These states cite their employer succession laws as protection against such practices because they require the transfer of experience ratings from one company to a successor company when ownership or management is substantially the same. However, DOL advised us that no states currently have laws prohibiting companies from using partial transfers of experience rating as a SUTA dumping practice.

The employee leasing industry provides contractor staff to client firms. The leasing company is usually responsible for the workers' wages and payroll taxes and may be considered their employer, even though work is performed at the client firm. Thus, the leasing agency, not the client firm,

[1] We sent the survey to the unemployment insurance administrators in the 50 states, District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Fifty administrators responded to the survey.

will acquire a higher experience rating if these workers claim unemployment benefits. Several states preclude this SUTA dumping practice by holding the client company responsible for unemployment insurance tax on the employees it leases. However, DOL told us that these laws do not preclude the client company from subsequently using other SUTA dumping practices, such as affiliated shell transactions, to lower its tax rate.

Telephone Calls to Consultants

In an effort to determine whether and how consulting firms promote SUTA dumping methods, one of our agents placed telephone calls to four firms. The agent posed as a construction company owner having approximately 1,000 employees and doing business in Maryland, Pennsylvania, Delaware, and New Jersey. He asked each firm contacted about the feasibility of switching employees to another business entity in order to reduce unemployment insurance taxes.

One firm representative we spoke with recommended that we spin off part of our current company and form a new one to obtain lower unemployment insurance rates. He said that as long as we "have good strategies" and "have some kind of substance behind it," this practice is perfectly legal.

Another firm representative suggested "moving your employees on paper into another type of organization to assume a better rate." He stated, "It more or less becomes kind of a shell game where … you're moving people around periodically to obtain more favorable rates." The representative stated that this practice is legal but added, "it becomes more of an ethical issue."

A third firm representative told us that if employees are simply switched to a newly created company, the state will transfer the experience rating of the old company to the new one unless you "misrepresent your company." Instead, he suggested lowering the rate by merging with another company that has a better rate.

The fourth firm representative we contacted stated that some people file for a new tax identification number and move all their employees on paper over to that new tax number to obtain a lower experience rating. The representative stated that this is illegal in many states but is allowable in others if some discernable event occurs, such as an asset transfer or formation of a new business division. The representative was very cautious

about this type of strategy, however, and said, "If you want that done, we're probably not your best company."

Mr. Chairman, this concludes my statement. At this time, Mr. Desaulniers will play excerpts from the tapes of two conversations he had with these consultants. (See app. I for these extracts.) We will then answer any questions that you or other members of the Subcommittee may have.

Contacts and Acknowledgement

For further information regarding this testimony, please contact Robert J. Cramer at (202) 512-7455 or Paul Desaulniers at (202) 512-7435. Individuals making contributions to this testimony included Jennifer Costello and Barbara Lewis.

MR. DESAULNIERS: Now, do I have to buy another construction business or --

CONSULTANT # 1: No, you could do this through -- you know, with your own internally. You're going to say, hey, look, we want to separate our costs internally, we don't want to, you know, have these costs combined, we're going to -- these these --

let's say the stable employees or the office employees shouldn't be reported and getting killed under these other -- where the union guys are being reported or where the construction workers are being reported. So we need to separate them out.

You don't have to buy another company, but it's how you create that company, because the spin-off means there's going to be a new company forming.

MR. DESAULNIERS: Okay.

CONSULTANT # 1: And that company's going to have its own unemployment rate.

MR. DESAULNIERS: Okay. And –

CONSULTANT # 1: How you establish that rate, that's what we do.

MR. DESAULNIERS: But it's not illegal or anything?

CONSULTANT # 1: No, it's -- none of it is illegal as long as you have good other additional strategies behind it.

MR. DESAULNIERS: Okay. But, I mean, if I'm just switching out the employees that are turning over --

CONSULTANT # 1: Well, you may want to switch out, you know, some of their office assets. You know what I mean? Like their computers, they're the ones that are using them, the telephones and stuff like that --

MR. DESAULNIERS: Just to kind of give it the impression that it's something –

CONSULTANT # 1: Right, of substance, of substance. You don't want to just --

MR. DESAULNIERS: Okay. I got you.

CONSULTANT # 1: You don't want to just roll employees.

MR. DESAULNIERS: That's good for next year. What happens if I, you know -- that rate eventually is going to go back up; right?

CONSULTANT # 1: Yeah, possibly and --

MR. DESAULNIERS: All right.

And what do I do down the road?

CONSULTANT # 1: Well, for the construction employees there's not much that can be done. They're going to be coming in to that company and --

MR. DESAULNIERS: I mean, can I do the same thing over again?

CONSULTANT # 1: You can, sure, but, then again, if you continually do it, you need to have some kind of substance behind it.

MR. DESAULNIERS: Okay.

CONSULTANT # 1: There's got to be an additional reason and --

MR. DESAULNIERS: You just have to keep making up some reason to –

CONSULTANT # 1: Keep, keep justifying why you're doing it and whether this year it's because you want to separate north from south -- hourly from salary, union from nonunion…

CONSULTANT # 2: The bigger area for savings in a construction industry and a multi-state employer is managing your taxes and understanding if you have options insofar as, you know, like you had talked about possibly,

you know, moving your employees on paper into another type of organization to assume a better rate. And it will in fact gain you a better rate, but it is a temporary fix. Eventually, if you have that same unemployment claim activity, it will catch up to you.

MR. DESAULNIERS: Right.

CONSULTANT # 2: But you will experience some savings.

MR. DESAULNIERS: Okay. I mean, is that tough to do?

CONSULTANT # 2: Well, more and more employers -- excuse me -- more and more states are trying to move away from that. It used to be somewhat common employers would do that, especially in the construction industry, but more and more employers --

excuse me -- more and more states are kind of catching on to the fact that this is what employers are doing. While it is legal, I think they're looking to kind of move away from that.

MR. DESAULNIERS: I mean, what is preventing you from doing the same thing another year or two later?

CONSULTANT # 2: That's a good question. I mean, it really becomes more of an ethical issue at that point. It more or less becomes kind of a shell game where you kind of -- you're moving people around periodically to obtain more favorable rates.

MR. DESAULNIERS: I mean, is it legal?

CONSULTANT # 2: It is, it is, but it's something that, as I said, states -- and there's a couple in particular that are -- and none of them ones that you had mentioned --

are cracking down on it and where they won't allow you to do that anymore. It's -- what they call it is SUTA number dumping.

So you kind of dump all your employees into this particular new number to obtain a more favorable rate. Typically it's a new employer rate, which is probably lower than where you are.

You get that more favorable rate. You're locked into it for a period of time so your rate won't increase. But at the end of that period, the state will then look at what you've paid in, what they've paid out and they will adjust it accordingly.

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