

Employment and Training Administration Advisory System U.S. Department of Labor Washington, D.C. 20210	CLASSIFICATION UI
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ADVISORY: UNEMPLOYMENT INSURANCE PROGRAM LETTER NO. 34-02

TO: ALL STATE WORKFORCE AGENCIES

FROM: CHERYL ATKINSON /s/
 Administrator
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 Security

SUBJECT: Tax Rate Manipulation - State Unemployment Tax (SUTA)
 Dumping

- Purpose.** To alert states to the expansion of "SUTA Dumping" into industries other than Professional Employer Organizations (PEOs), such as temporary help firms and service organizations, and to recommend possible approaches to help curb this activity.
- References.** Employee Leasing: Implications for State Unemployment Insurance Programs, Final Report, KRA Corporation, issued August 31, 1996; Effect of Employee Leasing on the State of Georgia Unemployment Insurance Trust Fund (UTF), Final Audit Report No. 03-98-007-03-315, Office of Inspector General (OIG), issued December 9, 1998.
- Background.** "SUTA Dumping" is a new term for an old activity. It was first discovered by states as a method used by the "employee leasing" industry, now known as PEOs, to avoid high unemployment insurance (UI) tax rates. Two types of SUTA Dumping transactions are discussed below:
 - Purchased Shell Transactions.** A leasing company purchases a small business that has a low to minimum tax rate. The low/minimum tax rate is transferred to the leasing company under state laws dealing with employer succession and transfer of experience. Once the experience is transferred and a low/minimum rate established, the leasing company begins leasing operations. The new leasing company either uses this low tax rate as a selling point to potential clients by offering a lower UI tax rate than the prospective client company has, or it takes the profits for itself by continuing to charge the client at the higher tax rate.
 - Affiliated Shell Transactions.** An already established and operating leasing company forms a number of additional corporations, obtains a UI account number for each, reports wages for a small number of individuals and pays state UI taxes on those wages until each additional corporation earns a minimum tax rate. Then the major portion of the original leasing company's employees is moved to a corporation with a minimum tax rate allowing it to effectively "dump" the higher tax rate earned by the original company and maintain a low UI tax rate.

RESCISSIONS	EXPIRATION DATE
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None

August 31, 2003

This type of UI tax rate manipulation, or "SUTA Dumping," by the leasing industry was documented in a study completed in August 1996, by KRA Corporation. The study, funded by the U.S. Department of Labor (Department), was entitled, Employee Leasing: Implications for State Unemployment Insurance Programs. It was again documented in October 1998 in the Department of Labor, OIG, Final Audit Report No. 03-98-007-03-315: Effect of Employee Leasing on the State of Georgia Unemployment Insurance Trust Fund.

Both the KRA study and the OIG audit concluded that such manipulative activity could result in a loss of state UI tax revenue. This loss of revenue translates into a socialization of costs as all employers would pay increased taxes to offset the loss in unemployment funds. Both reports also concluded that these types of transactions could occur in industries other than employee leasing.

The Department recently learned that "SUTA Dumping" has been detected in other industries that tend to have high turnover of staff and high UI costs, including temporary help, construction, and service organizations such as the hospitality industry. The Department has also learned that certain advisory companies are promoting this type of activity as a way of reducing expenses and increasing profits.

4. **Discussion.** "SUTA Dumping" compromises experience rating systems by eliminating the incentive for employers to keep employees working and returning claimants to work as soon as possible and unfairly shifts costs to other employers. In order to maintain the integrity of their experience rating systems and unemployment funds, states should promote legislation to deter UI tax rate manipulation schemes and ensure they are detected early and immediately corrected when found.

Examples that deter "SUTA Dumping" can currently be found in several state laws:

- Delaware Unemployment Compensation Law, § 3353(a), states:
Transfers of employment and benefit wage experience from a predecessor to a successor employer shall be required by the Department if there is a substantial continuity of ownership and management by the successor of the business of the predecessor. For the purpose of this section, such a transfer will be considered a 'mandatory transfer.'
- California Unemployment Insurance Code, Section 135.1 states, in part:
 - (a) A new employing unit shall not be created when there is an acquisition or change in the form or organization of an existing business enterprise, or severable portion thereof, and there is a continuity of control of the business enterprise. (b) Control of a business enterprise may occur by means of ownership of the organization conducting the business enterprise, ownership of assets necessary to conduct the business enterprise, security arrangements or lease arrangements covering assets necessary to conduct the business enterprise, or a contract when the ownership, stated arrangements or contract provide for or allow direction of the internal affairs or conduct of the business enterprise... (d) An employing unit described in subdivision (a) shall continue to be the same employer for the purposes of this code as before the acquisition or change in form.
- Texas Unemployment Compensation Act, Section 204.083, states:
An employing unit that acquires all of the organization, trade, or business of an employer and that continues operation of the organization, trade, or business acquires the compensation experience of the predecessor employer if on the date of the acquisition, a shareholder, officer, or other owner of a legal or equitable interest in the predecessor employer, or the spouse or a person within the first degree of consanguinity or affinity, as determined under Chapter 573, Government Code, of the shareholder, officer, or other owner: (1) is a shareholder, officer, or

other owner of a legal or equitable interest in the successor employing unit; or (2) holds an option to purchase a legal or equitable interest in the successor employing unit.

While California law makes the determination that the same employer is in existence and therefore maintains the same tax rate, Delaware and Texas require a transfer of experience when there is a continuity of ownership and management from the predecessor to the successor companies. Both of these approaches deter owners of a company that have formed additional companies, owned by basically the same individuals, from transferring all their employees into the company with the lowest tax rate and dumping the higher tax rate.

Some state laws have incorporated language that precludes a PEO from being considered a successor to one of its client companies. Similar language could be utilized for other industries where activity such as buying small businesses for the purposes of obtaining a low tax rate is found to be occurring.

Delaware law further states at §3353(b): "Transfers of employment and benefit wage experience from a predecessor to a successor employer may be approved by the Department, upon request of the successor employer, if there is a continuation of essentially the same business activity as the predecessor employer by the successor employer. For the purpose of this section, such a transfer will be considered a 'voluntary transfer.'" The requirement to continue the business activity of the predecessor employer prevents a company from buying an unrelated business simply to acquire its experience and then discontinue the business activity of the predecessor.

In addition to the above, the Department recommends that instead of simply correcting the files when discovered, states should amend their laws to allow the imposition of penalties on companies found to be illegally manipulating tax rates. For example, state law could require assigning the maximum tax rate under state law for a specified period of time. Such a penalty could also be imposed on advisory firms promoting illegal schemes. If it is found to be a serious violation of law, a state may wish to consider criminal charges.

5. **Action Required.** State Administrators are requested to provide copies of this advisory to the appropriate staff.

6. **Inquiries.** Questions should be directed to the appropriate Regional Office.