

**TESTIMONY OF MASON BISHOP
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EMPLOYMENT AND TRAINING ADMINISTRATION
U.S. DEPARTMENT OF LABOR
BEFORE THE SUBCOMMITTEE ON HUMAN RESOURCES
AND THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES**

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Good Afternoon, Chairmen Herger and Houghton and distinguished members of the Subcommittees. Thank you for inviting me to testify. I am extremely pleased to have the opportunity to discuss options for closing a loophole in many state unemployment insurance (UI) laws that permits some employers to pay less than their fair share of state unemployment taxes. As you know, the Administration is concerned that the administrative structure of the unemployment insurance system is an unwieldy relic. In both the 2003 and 2004 budgets, we have proposed a comprehensive package of reforms to respond to demands from employers, workers, and states, which have clamored for change for the past decade.

BACKGROUND

Most unemployment benefits are financed by employer-paid state unemployment taxes. All states currently determine an employer's tax rate in accordance with the requirements of Chapter 23 of the Internal Revenue Code of 1986 (commonly referred to as the Federal Unemployment Tax Act or "FUTA"). This statute requires that each employer's tax rate be related to its "experience with respect to unemployment," which is usually measured by the UI benefits paid to its former workers. Each employer has an account within the state's unemployment fund. In general, when a worker collects UI

benefits, the former employer's account is charged for the benefits paid. The more charges to the account, the higher the tax rate, up to a maximum set by state law. If the employer has a stable workforce with few layoffs, the charges and tax rate are low. Employers with higher turnover generally pay higher taxes. This tax determination system is known as "experience rating." A new employer who does not yet have sufficient experience to qualify for a rate based on experience is assigned a beginning tax rate, referred to as a "new employer rate."

Experience rating has been an important part of the federal-state UI system since its enactment in 1935. The allocation of unemployment benefit costs through experience rating incorporates these benefits as a cost of business borne by employers. States have a great deal of latitude in deciding what percentage of their benefit costs will be experience-rated and what percentage will not be assigned strictly to individual employers, but will be shared by the state's employers as a whole. Experience rating helps ensure an equitable distribution of costs among employers based on an employer's experience with UI. It also encourages employers to stabilize their workforce and provides an incentive for an employer to contest claims when employees quit or are fired for cause, since the cost attributable to claims may affect the unemployment tax rate of the employer.

However, over the past several years, some employers have found ways to manipulate experience rating so that they pay lower state UI taxes than they should based on their UI benefit experience. This abusive practice is commonly called "SUTA dumping," and it can deprive states of the revenues they need to provide workers the

unemployment benefits to which they are entitled under state law. (“SUTA” refers to state unemployment tax acts.)

SUTA dumping generally occurs in two ways. First, some employers escape poor experience (and high tax rates) by setting up a shell company and then transferring some, or all, of their payroll to the shell company after it has operated for several years with low turnover and earned a low tax rate based on that experience. As a result, in situations where there has been no change in ownership or management and no change in the business activity that would justify a reduced tax rate, the poor experience is “dumped” through the use of the shell company that has been assigned a lower state unemployment tax rate. We believe that when an employer transfers its payroll to another employer with the same ownership and management, the experience attributable to the transferred business activity should be transferred to the acquiring employer. This transfer would assure that employers do not set up shell companies to avoid their liability for UI taxes because the shell company would absorb the prior UI experience, as well as the business activity itself.

In the second case, a small employer that has a low UI tax rate is bought by a person who does not currently employ any workers. The new owner ceases the business activity of the small employer and commences a different type of business. For example, a person who is not an employer buys a small flower shop that has a low UI tax rate. The new owner subsequently stops doing business as a flower shop and begins a temporary staffing business, while keeping the lower UI tax rate earned by the flower shop. The result is that the new owner avoids the rate normally assigned to new employers and receives the flower shop’s lower tax rate. We believe that this type of abuse should be

addressed by prohibiting experience transfers to the new owner *if* the state agency finds that a business was acquired solely or primarily for the purpose of obtaining a lower rate of contributions. However, states should be free to establish their own criteria for making such a finding that the acquisition was for the purpose of obtaining a lower rate of contributions. States that currently prohibit the transfer of experience in this situation generally look to whether the new owner continues the same business activity in determining if the acquisition was for the purpose of obtaining a lower rate of contributions. Following the same example, if a flower shop is acquired, the new owner must continue to operate the flower shop in order to obtain a UI tax rate based on the flower shop's UI experience.

Through a Department-funded study issued in 1996 and an OIG Final Audit Report issued in 1998, we learned that SUTA dumping had occurred in some parts of the employee leasing industry and could be expanded into other industries. We have since learned that consulting firms actively market SUTA dumping to various industries with high UI costs as a way of reducing taxes and increasing profits. Some employers feel pressured to participate in this manipulation to avoid being put at a competitive disadvantage.

SUTA dumping can deprive the state's unemployment fund of revenues and will shift some benefit costs to other employers. We believe that those most affected by cost shifting are smaller employers who have neither the expertise nor the resources to set up such schemes, and employers with low UI costs who have no need to participate in these schemes.

DEPARTMENTAL ACTIONS

To address this serious issue, the Department of Labor's Employment and Training Administration has issued guidance advising states of SUTA dumping and alerting them to provisions enacted by some state legislatures that eliminate or reduce the practice of SUTA dumping. We were pleased to learn that North Carolina paid careful attention to this matter and enacted legislation that clarified that an employer cannot avoid a UI tax rate based on the previous experience of the employer in the UI system by simply shifting its employees to a shell company that enjoys a lower UI tax rate. North Carolina's legislation also raised the penalty for evading UI taxes from a misdemeanor to a felony. I will defer to the witness from North Carolina to provide the details of the state's actions.

In addition, the Administration is reviewing legislative remedies that would curb the practice of SUTA dumping. Our remedy under consideration would amend FUTA to provide for the required and prohibited transfers previously discussed. Such a provision would result in millions per year in UI taxes being paid by the employers responsible for the costs rather than have those costs shifted to other employers.

This remedy could also authorize the Secretary to draft regulations to address any methods of SUTA dumping not already discussed. This approach would aim to discourage employers from devising new tax avoidance schemes or loopholes since the Secretary would be authorized to close them. Finally, the remedy could require the states to impose a penalty on any person who willfully circumvents those provisions of state laws implementing the above amendments to FUTA, including financial advisors who may offer advice leading to willful circumvention. The intent behind these penalties

would be to encourage compliance. States would be free to determine the penalties for violations of their laws, which could take the form of fines, increased state UI tax rates, loss of relevant licenses, and even jail for egregious violations.

The Administration strongly believes that no new requirements should be imposed on states unless there is a compelling need. Any legislative remedy should be crafted in a way that minimizes the impact on legitimate business mergers, acquisitions and reorganizations, and on current state law. States should not be required to completely overhaul their provisions on transfers of experience in order to eliminate this abuse by a relatively small number of employers.

CONCLUSION

In sum, manipulation of state tax rates is of great concern to the Department and we look forward to working with the Committee on this issue. SUTA dumping can have a negative impact on state unemployment funds by forcing all employers to pay more UI taxes to compensate for the revenue lost as a result of the few who avoided taxes. To maintain the integrity of their experience rating systems and unemployment funds, states should enact legislation to deter UI tax rate manipulation schemes, and they should ensure such schemes are detected early and immediately corrected.

This concludes my remarks. I will be glad to answer any questions you may have. Thank you.