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UNEMPLOYMENT FRAUD AND ABUSE

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

AND

SUBCOMMITTEE ON HUMAN RESOURCES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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UNEMPLOYMENT FRAUD AND ABUSE

THURSDAY, JUNE 19, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
SUBCOMMITTEE ON HUMAN RESOURCES,
Washington, DC.

The Subcommittees met, pursuant to notice, at 2:05 p.m., in room 1100, Longworth House Office Building, Hon. Wally Herger (Chairman of the Subcommittee on Human Resources) presiding.

[The advisory and the revised advisory announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON HUMAN RESOURCES

FOR IMMEDIATE RELEASE
June 10, 2003
OV–5

CONTACT: (202) 225–7601

Houghton and Herger Announce Joint Hearing on Unemployment Fraud and Abuse

Congressman Amo Houghton (R–NY), Chairman of the Subcommittee on Oversight, and Congressman Wally Herger (R–CA), Chairman of the Subcommittee on Human Resources, Committee on Ways and Means, today announced that the Subcommittees will hold a joint hearing on unemployment fraud and abuse. **The hearing will take place on Tuesday, June 17, 2003, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2:00 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include representatives of the U.S. Department of Labor (DOL), U.S. General Accounting Office (GAO), and other interested individuals.

BACKGROUND:

The Unemployment Compensation (UC) program (sometimes referred to as Unemployment Insurance or UI) is a State-Federal partnership under which benefits are paid to laid-off workers who have a history of attachment to the workforce. Within a broad Federal framework, each State designs its own UC program.

Federal payroll taxes paid by employers support Federal responsibilities in the unemployment system, including certain administrative expenses, loans to States, and the Federal half of costs under the permanent Extended Benefits (EB) program. State payroll taxes support regular unemployment benefits and the State half of the EB program, among other costs. Both the Federal and State taxes collected for unemployment purposes are held in trust fund accounts that are part of the unified Federal budget.

Employers may be eligible for a lower State payroll tax rate based on the experience of their employees in collecting unemployment benefits. States use a variety of experience rating systems to assign tax rates to employers, with those whose employees receive benefits the least having lower tax rates, and those employers whose employees receive benefits most frequently having higher rates. These rates can change yearly, based on annual computations.

A December 31, 2002, Program Letter issued by the DOL alerted States to "State Unemployment Tax Act (SUTA) dumping" activities designed to undermine effective experience rating. The DOL highlighted approaches used by some employers to avoid high unemployment tax rates, including various "shell" transactions involving the artificial manipulation of corporate structures or employees. Such activity, according to DOL, "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." Some, but not all States, have enacted legislation designed to prevent SUTA dumping.

In announcing the hearing, Chairman Houghton stated, "I have to believe that congressional oversight is critical to the integrity of the UC program. This hearing will basically review whether tax strategies have undermined the program, and if so, what can be done to fix it."

Chairman Herger said, "The Nation's UC program provides a much needed safety net to workers laid off through no fault of their own. State Unemployment Tax rate manipulation, or SUTA dumping threaten workers, employers, and States by slowing returns to work, shifting taxes from businesses responsible for layoffs to other employers, and undermining trust fund solvency. This hearing will review the extent of this activity, what its effects have been, and what, if any, legislative action is needed to protect workers and employers who play by the rules."

FOCUS OF THE HEARING:

The hearing will focus on "SUTA dumping."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, by the close of business, Tuesday, July 1, 2003. Those filing written statements who wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the Subcommittee on Oversight in room 1136 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225-2610, in WordPerfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

*** * * NOTICE—CHANGE IN DATE * * ***

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON HUMAN RESOURCES

FOR IMMEDIATE RELEASE
June 12, 2003
OV–5–Revised

CONTACT: (202) 225–7601

Change in Date for Joint Hearing on Unemployment Fraud and Abuse

Congressman Amo Houghton, (R–NY), Chairman of the Subcommittee on Oversight, and Congressman Wally Herger, (R–CA), Chairman of the Subcommittee on Human Resources, Committee on Ways and Means, today announced that the joint hearing on unemployment fraud and abuse, previously scheduled for Tuesday, June 17, 2003, at 2:00 p.m., in the main Committee hearing room, 1100 Longworth House Office Building, **will be held, instead on Thursday, June 19, 2003, at 2:00 p.m.**

All other details for the hearing remain the same. (See Subcommittee Advisory No. OV–5 released on June 10, 2003.)

Chairman HERGER. Good afternoon, and welcome to today's hearing on Unemployment Fraud and Abuse. It is a pleasure to be here with Chairman Houghton and other Members of the Subcommittee on Oversight.

This Congress is very aware of the needs of families with unemployed workers. We created a special Federal program that will provide $24 billion in special extended benefits to 8 million workers through March 2004. We provided $8 billion more to States to assist the unemployed, which has helped to keep payroll taxes down in 30 States. The President recently signed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108–27), which includes another $20 billion that States can use for struggling families. So, we have helped millions of workers, while taking steps to strengthen the economy and create more jobs—which is what workers really want.

The issue before us today is a threat to the Nation's unemployment benefit system. At issue is whether some employers wrongly minimize, or even avoid, paying their proper share of State unemployment taxes. In program jargon, this practice is known as State Unemployment Tax Acts (SUTA) (Social Security Act, 1935, 49 Stat. 620) dumping—SUTA should prevent this practice, but apparently doesn't in many cases.

We will hear about several schemes which share a common thread. They all seek to thwart a basic purpose of the Nation's unemployment program since the 1930s—that employer taxes should be based on the experience of their employees in collecting unemployment benefits. In short, if an employer lays off lots of workers,

that employer is supposed to pay more taxes to support unemployment benefits than an employer who rarely or never lays off workers. As we will hear today, that longstanding role is under attack by some employers attempting to dump their costs onto others.

There is no better time to review this issue. Now, more than ever, the Nation's unemployment system needs to be working at maximum efficiency to provide benefits to workers. There are a number of reasons for Federal attention. One key Federal role is to ensure that this program is working efficiently and fairly. We are also concerned about the solvency of State trust funds, and the need for Federal loans for some States to pay benefits.

I believe that SUTA dumping could quickly undermine program solvency. That could lead to higher payroll taxes for all employers, threatening our economic growth and job creation. Our oversight responsibilities merit a close look at this issue, and any appropriate responses. At this hearing today, we will hear from the U.S. Department of Labor, the U.S. General Accounting Office (GAO), a State that has recently taken steps to prevent SUTA dumping, and an employer who will tell us of the risk this practice poses for legitimate businesses. I look forward to all the testimony we will receive. Without objection, each Member will have the opportunity to submit a written statement and have it included in the record at this point. Mr. Cardin, would you like to make an opening statement?

[The opening statements of Chairman Herger and Mr. Pomeroy follow:]

Opening Statement of the Honorable Wally Herger, Chairman, Subcommittee on Human Resources, and a Representative in Congress from the State of California

Good afternoon and welcome to today's joint hearing on unemployment fraud and abuse. It is a pleasure to be here with Chairman Houghton and other Oversight Subcommittee Members.

This Congress is very aware of the needs of families with unemployed workers. We created a special Federal program that will provide $24 billion in temporary extended benefits to 8 million workers through March 2004. We provided $8 billion more to States to assist the unemployed, which has helped keep payroll taxes down in 30 States.

The President recently signed the Jobs and Growth Tax Bill, which includes another $20 billion that States can use for struggling families. We have helped millions of workers, while taking steps to strengthen the economy and create more jobs, which is what workers really want.

The issue before us today is a threat to the Nation's unemployment benefits system. At issue is whether some employers wrongly minimize or even avoid paying their proper share of State unemployment taxes. In program jargon, this practice is known as "SUTA dumping," for State Unemployment Tax Acts that should prevent this practice, but apparently don't in many cases.

We will hear about several schemes, which share a common thread. They all seek to thwart a basic purpose of the Nation's unemployment program since the 1930s—that employer taxes should be based on the experience of their employees in collecting unemployment benefits.

In short, if an employer lays off lots of workers, that employer is supposed to pay more taxes to support unemployment benefits than an employer who rarely or never lays off workers. As we will hear today, that longstanding rule is under attack by some employers attempting to dump their costs onto others.

There is no better time to review this issue than now. Now more than ever the Nation's unemployment system needs to be working at maximum efficiency to provide benefits to workers. There are a number of reasons for Federal attention. One key Federal role is to ensure this program is working efficiently and fairly. We also are concerned about the solvency of State trust funds, and the need for Federal loans for some States to pay benefits.

SUTA dumping could quickly undermine program solvency. That could lead to higher payroll taxes for all employers, threatening economic growth and job creation. Our oversight responsibilities merit a close look at this issue and any appropriate responses.

At this hearing today, we'll hear from the U.S. Department of Labor, the General Accounting Office, a State that has recently taken steps to prevent SUTA dumping, and an employer who will tell us of the risks this practice poses for legitimate businesses.

I look forward to all the testimony we will receive.

Opening Statement of the Honorable Earl Pomeroy, a Representative in Congress from the State of North Dakota

I am pleased that the Ways and Means Oversight Subcommittee is joining the Human Resources Subcommittee to examine an issue of mutual interest and concern. Today's hearing deals with our Federal-State Unemployment Compensation (UC) program and alarming reports of fraud and abuse by employers.

Briefly, the UC program provides cash benefits to laid-off workers while they are actively seeking new employment. Their benefits are funded by employers who pay State UC taxes into State unemployment trust funds. Employers' tax payments are determined, in part, by a company's "experience rating." Companies that have fewer employees drawing UC benefits will have lower tax rates than companies that routinely lay off workers.

Unfortunately, many employers are engaging in activities to artificially and fraudulently reduce their State UC taxes. The Department of Labor and General Accounting Office recently have reviewed this abuse and determined that "SUTA dumping" is a serious problem for States. When employers fail to pay their fair share of UC taxes, States lose millions of dollars. This could result in increased tax rates for all employers.

According to a recent GAO survey, approximately three-fifths of States believe that their own laws are insufficient to combat this abuse and that their enforcement efforts are inadequate. Further, fourteen States recently have identified specific "SUTA dumping" employers who created losses to the their States of more than $120 million.

I want to thank Human Resource Chairman Herger and Ranking Member Cardin for bringing this issue to our subcommittees' attention. As always, I particularly want to commend Oversight Subcommittee Chairman Houghton for his leadership on this and other important matters facing our Country.

Mr. CARDIN. Well, thank you very much, Mr. Chairman. First, let me start off by commending both you and Chairman Houghton for holding this joint hearing of the Subcommittee on Human Resources and the Subcommittee on Oversight of the Committee on Ways and Means, to take a look at one of our principal responsibilities—to make sure that the unemployment compensation system is working in our various States. One of the things we need to be careful about, is those people who are not playing according to the rules. It is not fair to the employers who are doing what is right.

As you point out, this SUTA dumping results in companies trying to reduce their premium for unemployment insurance (UI) at the expense of either the solvency of the State fund, or at the expense of other employers who are required to pay higher premiums as a result of the SUTA dumping. In either case, that is not right. Our Committee has the responsibility to make sure that the laws are being complied with, and that we don't have these shell companies set up in order to reduce the rates for companies.

I understand that the Department of Labor will be testifying. Mr. Bishop, we look forward to your testimony. You may be offering some suggestions in this area, and I think that will be very helpful

to us in our work. In this context, though, let me mention one additional problem, Mr. Chairman—or, Joint Chairmen—that I think we should take a look at. That is, the companies that avoid paying any of the unemployment taxes. They do that by classifying people as independent contractors when, in fact, they are employees in many cases. These are cases where a person controls the actions of other individuals, as traditional employment would indicate, but are classified as an independent contractor in order to avoid, not only paying the UI taxes, but the other payroll taxes as well.

The Department of Labor, 3 years ago, suggested that 80,000 workers may be denied unemployment benefits every year because they are misclassified as independent contractors—80,000 a year. With SUTA dumping, as tragic as it is, normally, it doesn't deny people benefits; it affects the way employers pay into the fund. That is very serious, but in this case, 80,000 people, in fact, are denied from receiving any of their benefits.

So, I would urge this Committee, as we take a look at what is happening on SUTA dumping, expand our review to also look at the independent contractor issues and other issues that might be denying people benefits that they are otherwise entitled to, or adversely affecting those companies that are trying to play according to the rules. I look forward to hearing from all of our witnesses, and working with my fellow Members of the Committee.

[The opening statement of Mr. Cardin follows:]

Opening Statement of the Honorable Benjamin L. Cardin, a Representative in Congress from the State of Maryland

Mr. Chairman, let me start by commending you and Chairman Houghton for conducting this joint hearing on fraudulent practices used by some employers to evade their fair share of unemployment insurance taxes. Overseeing the administration and implementation of programs within our jurisdiction is an important responsibility for this committee.

Unemployment compensation for laid-off workers is funded through payroll taxes paid by employers to State unemployment trust funds. These assessments are based on the number of workers who file for benefits, meaning businesses who lay off more employees have higher tax rates. Some employers manipulate this system of experience rating by transferring employees into shell companies formed solely for the purpose of evading unemployment taxes.

This practice reduces the solvency of the States' unemployment trust funds, and it ultimately shifts more of the tax burden to responsible employers who play by the rules.

I understand the Department of Labor (DOL) may provide us with specific statutory recommendations to prevent this type of fraud, known as SUTA dumping. I look forward to examining DOL's suggested language and to working with the agency and my colleagues on this committee to ensure all employers contribute their fair share to the unemployment system.

In that context, it is worth mentioning there are other methods used by companies to avoid paying unemployment taxes.

For example, some employers misclassify certain workers as independent contractors—a step which denies the worker many benefits, including unemployment compensation. A study commissioned by the Department of Labor three years ago suggested that 80,000 workers may be denied unemployment benefits every year because they are misclassified as independent contractors.

In some ways this issue of misclassification may be an even greater problem than SUTA dumping because it deters workers from collecting unemployment benefits when they are laid-off.

While some complexities surround the definition of an independent contractor, I hope DOL will provide this committee with recommendations to prevent the intentional misclassification of employees as independent contractors.

If a business exerts control over how, when and where an individual conducts their work, but classifies them as an independent contractor for the purpose of

avoiding UI taxes, that is wrong and it should be stopped. I look forward to hearing from our witnesses on this and other forms of fraud. Thank you.

Chairman HERGER. Thank you, Mr. Cardin. Chairman Houghton of the Subcommittee on Oversight, would you like to make an opening statement?

Chairman HOUGHTON. I would, thank you very much. Thank you for letting us be here. We on the Subcommittee on Oversight are honored to be associated with those of you on the Subcommittee on Human Resources—although we are slightly outnumbered at this time. The topic today, of course, is a review of the practices that may result in abuses of the unemployment compensation program. Chairman Herger has outlined some of the key principles of the unemployment compensation system, which is administered jointly by the Federal and State governments.

As Members of the Subcommittee on Oversight, our interest, really, is in preventing any abuse of the program. I happen to believe that congressional oversight is critical to the integrity of it. So, I would like to yield to my associate, Mr. Portman, for any comments. I thank you very much for holding this hearing, and I am honored to be a Co-Chair with you.

Mr. PORTMAN. I thank the Chair. I have no further comments to add to your good ones, except to thank the Subcommittee on Human Resources for joining with us in this important look. I think it is the first of the fraud and abuse Subcommittee on Oversight hearings we are going to be having. So, I look forward to hearing from the witnesses, and dealing with the particular issue of SUTA dumping. I thank the Chair for yielding to me.

Chairman HERGER. Thank you. Before we move on to our testimony, I want to remind our witnesses to limit their oral statements to 5 minutes. However, without objection, all the written testimony will be made a part of the permanent record.

Mr. KLECZKA. Mr. Chairman.

Chairman HERGER. Yes.

Mr. KLECZKA. As the only other Member who hasn't spoken, also, as the Ranking Member on the Subcommittee on Oversight, I want to join my Chairman, Mr. Houghton, by saying how thrilled we are to be here with you. Listening to the opening remarks, I must say, I was not aware of the problem, so I look forward to the testimony of Mr. Bishop, and others, to indicate what is going on in the field. I do want to associate myself with the remarks made by Mr. Cardin as they relate to independent contractors. Not only are they affected, or ill-affected, by the unemployment compensation dumping that we are going to hear about, but also by misclassifying these employees as independent contractors. We know that they lose out on other benefits, the major one of which is the Federal Insurance Contributions Act (FICA) (Social Security Act, 1935, 49 Stat. 620)—the Social Security match from the employer. Mr. Houghton and I introduced legislation a session or two ago that would redefine what an independent contractor is. We have not done so again this session. To the folks here from the Department of Labor, that is a problem that is growing, and one of

these days we are going to have to look at that, also. So, Mr. Chairman, thank you very much.

Chairman HERGER. Thank you, Mr. Kleczka. Our first witness today is representing the Administration. I am pleased to welcome Mr. Mason Bishop, Deputy Assistant Secretary of the Employment and Training Administration, at the Department of Labor. Mr. Bishop.

STATEMENT OF THE HONORABLE MASON BISHOP, DEPUTY ASSISTANT SECRETARY, EMPLOYMENT AND TRAINING ADMINISTRATION, U.S. DEPARTMENT OF LABOR

Mr. BISHOP. Thank you, Chairman Herger, Chairman Houghton, and distinguished Members of the Subcommittees. Thank you for inviting me to testify today. I am extremely pleased to have the opportunity to discuss options for closing a loophole in many State UI laws that permit some employers to pay less than their fair share of State unemployment taxes.

Most unemployment benefits are financed by employer-paid, State unemployment taxes. An employer's tax rate is determined in accordance with the Federal Unemployment Tax Act (FUTA) (1954, 68A Stat. 439), which requires that each employer's tax rate be related to its experience with respect to unemployment, as measured by the UI benefits paid to its former workers. Each employer has an account within the State's unemployment fund which is charged for the benefits paid when a former worker collects UI benefits. The more charges to the account, the higher the tax rate—up to a maximum set by State law. Conversely, if the employer has a stable work force with few layoffs, the charges in tax rate are low.

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. 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 work force, 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.

Over the past several years, some employers have found ways to manipulate experience ratings so that they pay lower State UI taxes than they would based on their UI benefit experience. This abuse of practice is commonly called SUTA dumping, and can deprive States of the revenues they need to provide workers the unemployment benefits to which they are entitled under State law. As you know, we are good with acronyms, and SUTA refers to the State Unemployment Tax Acts.

Briefly, SUTA dumping generally occurs in two ways. First, the situation concerns employers setting up a shell company, and then transferring some or all of their payroll to the shell company to get 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 of the transferred business activity should also be transferred to the acquiring employer.

The second situation involves new owners avoiding new employer rates. 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 the new owner obtaining a lower rate of contributions.

Through a Department of Labor-funded study issued in 1996, and an Inspector General final audit report issued in 1998, we have learned that SUTA dumping had occurred in some parts of the employee leasing industry and could be expanded into other industries. Subsequently, we learned that consulting firms actively market SUTA dumping to various industries with high UI costs as a way of reducing taxes and increasing profits.

The act of 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.

To address this serious issue, the Department of Labor has issued guides advising States of SUTA dumping, and alerting them to provisions enacted by some State legislatures that eliminate or reduce its practice. We were pleased to learn that North Carolina paid careful attention to this matter, and enacted legislation that clarified that an employer cannot avoid its earned experience rating by shifting its employees to a shell company that enjoys a lower UI tax rate. The witness from North Carolina can provide details on their specific action.

The Administration is reviewing legislative remedies that would curb the practice of SUTA dumping, such as amending the FUTA to provide for the required or prohibited transfers previously discussed, along with penalties for willful circumvention. Any legislative remedies should be crafted in a way that minimizes the impact on legitimate business mergers, acquisitions, and reorganizations—and on current State law.

In summation, manipulation of State tax rates is of great concern to the Department of Labor, and we are willing to work with this Committee to curb this practice. This concludes my remarks, and I will be glad to answer any questions you may have.

[The prepared statement of Mr. Bishop follows:]

Statement of the Honorable Mason Bishop, Deputy Assistant Secretary, Employment and Training Administration, U.S. Department of Labor

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.

Chairman HERGER. Thank you, Mr. Bishop, for your testimony. I now will turn to questions. I would like to remind the Members that they each have 5 minutes for witness questions. Chairman Houghton, would you like to inquire?

Chairman HOUGHTON. Well, the question that was just going through my mind is that, with all the good intentions here—the SUTA dumping could continue through some sort of substance be-

hind it, behind whatever the activity was. Would you like to comment on that?

Mr. BISHOP. Excuse me—I am not sure I understand.

Chairman HOUGHTON. Well, one company, it says here in this piece of paper I have in front of me, suggested moving your employees on paper into another type of organization to assume a better rate—and that it more or less becomes a kind of shell game. Another company said that such activity was legal if there was some kind of a substance behind it. Would you like to comment on that?

Mr. BISHOP. Sure. Essentially, what we are targeting here, Mr. Chairman, is when a company specifically sets up a shell company for the express purpose of trying to lower their experience rating—specifically to pay lower unemployment taxes at the State level. That is what we are targeting. If a company has a legitimate business merger, we would not want any legislation to impact that legitimate business merger. What we are seeing now—a phenomenon that seems to be occurring more and more—is the opportunity of companies to set up specific shell corporations with the express intent to shift their experience rating to a lower rating.

Chairman HOUGHTON. If I want to set up a shell company, I am not going to say I am just setting up a shell company in order to move the employees around. I am going to have some set of reasonings behind it. Who is going to be making that judgment?

Mr. BISHOP. Well, the State UI agency would be primarily involved, because they are the ones that are administering the State UI laws at the State level. So, in North Carolina, it would be the Employment Security Department; in other States, it would be whatever agency that does the UI program. They would have to make that individual determination based on whatever Federal law or State law that are in effect, as well as any guidance in the Department of Labor.

Chairman HOUGHTON. They are not capable of doing that now?

Mr. BISHOP. Well, right now the problem is that not all States, in a consistent fashion, have set up State laws that prohibit this activity. So, there are loopholes that, essentially, are being used to lower the experience rating. So, it is very inconsistent.

Chairman HOUGHTON. Even in States that have set up a mechanism?

Mr. BISHOP. Well, States like North Carolina, which you will hear from later today, have specifically taken steps in their State law to prohibit this practice and assure that those business mergers that occur are legitimately done, and not with the express intent to shift experience rating to a lower rate.

Chairman HOUGHTON. Thank you very much.

Chairman HERGER. Thank you. The gentleman from Maryland, Mr. Cardin, to inquire.

Mr. CARDIN. Thank you, Mr. Chairman. Mr. Bishop, do you know when we might expect specific recommendations from the Administration to deal with this subject?

Mr. BISHOP. Yes, Mr. Cardin. We have been working on potential legislation, been reviewing that, and would like to work with the Committee currently, regarding what we would like to do together to address this issue.

Mr. CARDIN. Well, we always appreciate working with the Administration, but it is useful if we have specific recommendations. You have indicated two circumstances where you set up a shell company where the ownership is identical, or where you set up a transfer for the sole purpose, or the primary purpose, to reduce your experience rates. I think we all would agree, in those two circumstances, that we want to do something. So, I guess my question to you would be to give us some direction how—and I think this was Chairman Houghton's point. How could the Federal law be best crafted to encourage the States not only to take action in this area, but to take effective action in this area? These are two separate questions. I noticed that there are some States that have taken action, but we believe the enforcement is probably not there. So, I think guidance from you is going to be important to us. We want to work with you, but we need some specific guidance. I think only the Administration can at least get that started. So, we would appreciate something specific from you. Let me go to the second point that I mentioned in my opening statement. Well, first, before we leave the SUTA dumping, do you have any estimates as to how much might be involved here?

Mr. BISHOP. Unfortunately, Mr. Cardin, we don't have any real solid data estimates at this time. This is something that became, as I mentioned in my testimony, aware to us as a merging practice in the mid-1990s. It is something that in the last couple of years seems to be practiced more often. We plan on working with the States to stay on top of it, and try to gather more evidence as to what is actually happening out there from a specific data set.

Mr. CARDIN. In the next panel, GAO will report that 14 States have been surveyed, and about $120 million has been found. Do you have any reason to believe that that is not within the ball park of what we are talking about?

Mr. BISHOP. I think we would have every reason to believe that is, potentially, in the ball park.

Mr. CARDIN. Thank you. The last issue I'd like to address, is the one I mentioned during my opening comments about other areas where there is fraudulent action within the unemployment system, particularly dealing with independent contractors. There is obviously a financial advantage for a company to classify a worker as an independent contractor far beyond the unemployment compensation system. Is the Department of Labor looking at this issue to try to give some guidance to Congress so, again, those companies that are doing it right are not being over penalized by those companies that are taking or doing things that are not permitted under law?

Mr. BISHOP. Mr. Cardin, at this point we have not specifically issued any reports regarding this particular issue in the last few months. We would be more than willing to work with this Committee in looking at this issue and moving it forward if something needs to be done. I think it is a reasonable question to ask: what is the relationship of independent contractors within the context of the UI system, what are those impacts, and what does that mean? So, we would be more than willing to work with you on that.

Mr. CARDIN. Well, I very much appreciate your offer. We will certainly be back to you so that we can try to find some information in this area. Thank you, Mr. Chairman.

Chairman HERGER. Thank you. The gentleman from Ohio, Mr. Portman, to inquire.

Mr. PORTMAN. Thank you, Mr. Chairman. Mr. Bishop, thank you for your testimony and your work on this. I have sort of an elementary question. I know that we are going to have other testimony that will address this matter, but this is a partnership with the States and the Federal Government, that our Federal unemployment taxes—clearly we have a stake in this, because if there is dumping, that means we are not getting as much money into the Federal tax coffers. Is that correct?

Mr. BISHOP. No, that is not correct, Mr. Portman. This is a State—again, we have a Federal tax that is collected for the purposes of administering the UI system.

Mr. PORTMAN. Right.

Mr. BISHOP. We have State taxes that are collected for the benefit side. We are talking about the State taxes now. It is employers who are paying less——

Chairman HOUGHTON. Could I interrupt? Could you speak just a little bit louder?

Mr. BISHOP. Yes, excuse me. I am sorry, Chairman Houghton. This is a State unemployment tax issue.

Mr. PORTMAN. According to testimony that is coming up next, the State taxes are actually at the U.S. Department of the Treasury. Is that correct?

Mr. BISHOP. Right. It is held at the——

Mr. PORTMAN. What I am trying to find is the right nexus at the Federal level. An obvious question would be, why does there need to be any Federal law here? Some States, like North Carolina, have been more aggressive, passed strong legislation, and are actually enforcing those laws. Other States have passed legislation. Maybe their enforcement is a little lax. Some States have chosen not to pass legislation. Some of those States, based on your own survey, indicate that they think everything is fine in their State, even though they don't have legislation.

So, my question to you would be, what is the Federal nexus here? Why would it be appropriate for us to have new Federal legislation in this issue? Is it something that really is more appropriately left up to the States, or should there be some Federal involvement?

Mr. BISHOP. Well, as you know, in the UI system, that is one of the core questions on any issue that is brought up—is it best determined at a State level or at a Federal level? In this particular case, we believe the appropriate level is at the Federal level, because we believe that this is an issue of fraud and abuse of the UI system, and we believe that it is an appropriate role of the Federal Government to address issues of fraud and abuse across the UI system.

Mr. PORTMAN. Since the Department of Labor has responsibility, overall, for administering the program and, therefore, has a responsibility to ensure that there is not fraud and abuse?

Mr. BISHOP. Correct.

Mr. PORTMAN. What would you recommend in terms of a Federal law which would mandate every State to enact legislation; or would you rather see a Federal law which deals with things like transfer—and I know one of the witnesses coming up is going to talk about that. For instance, when there is a merger or acquisition, there is a transfer of experience. What would you think the appropriate Federal legislation would say?

Mr. BISHOP. What we are looking at with the context of Federal legislation, right now, would be language that would actually say something to the effect of, in the context of a transfer, it would be for business purposes. So, we would be looking at that kind of language at the Federal level to recommend—to assure that this kind of thing does not happen.

Mr. PORTMAN. To avoid the sham company issue?

Mr. BISHOP. Right.

Mr. PORTMAN. Then, how would you address the other issues that you have raised? Let us talk about the transfer issue generally. That isn't a shell company or a sham company issue, is it?

Mr. BISHOP. It is the new employer. It is a new employer who purchases an existing company that is unrelated to the business—that they are going to be engaging in for the express purpose of getting that employer's UI tax rate, so that they don't have to pay the new employer rate.

Mr. PORTMAN. What would you recommend in terms of Federal legislation?

Mr. BISHOP. What we would do would be to prohibit the transfer experience from an acquired employer to the purchaser, the new employer in those instances, where it is unrelated to the business of the new employer.

Mr. PORTMAN. In all acquisitions or mergers?

Mr. BISHOP. No. If you were a new employer, and you acquired an existing business that was in the same industry or same line of business you were going to be doing, that would be a legitimate kind of business acquisition. If I am starting an auto parts store as an independent business owner, I buy a flower shop, and I don't have anything to do with flowers anymore, I just take the experience rate of that company—under our proposal, that would not be allowed anymore.

Mr. PORTMAN. Is your sense that most States know whether there is dumping or not? The Congressional Research Service study said that there is $53 billion being paid to over 10 million claimants. Out of that amount, I think the number we had was $120 million out of the $53 billion maybe being dumped. That is based on your study, saying that 14 States identified that. Do you think it is a bigger problem than that—that there is in excess of 14 States? Ohio, as an example, my State, indicates that they don't believe they have a dumping problem. They are concerned about it because they don't want it to migrate to Ohio. Do you think that it is a bigger problem than you identified in those 14 States?

Mr. BISHOP. Well, we think it is an emerging problem that has the potential to get very big. We have firms that are actively promoting, doing this kind of activity. We think the GAO study is in the ball park of where we are at currently, but this has the potential of turning into a much bigger issue.

Mr. PORTMAN. From $10s of millions to billions?

Mr. BISHOP. Potentially.

Mr. PORTMAN. Thank you, Mr. Chairman.

Chairman HERGER. Thank you. The gentleman from Michigan, Mr. Levin, to inquire.

Mr. LEVIN. Thank you. Mr. Portman asked appropriately for the linkage here with the Federal role and the Federal Government. The monies based on experience rating are essentially usable by the States to pay unemployment compensation, right?

Mr. BISHOP. Correct.

Mr. LEVIN. If the States have less money than they need, then they can borrow from the Federal Government. Right?

Mr. BISHOP. Correct.

Mr. LEVIN. So, there is that additional linkage, is there not? Now, a number of States are borrowing from the funds in the federal trust funds. Right?

Mr. BISHOP. Currently, we have three States in a borrowing status with a couple more about to borrow, it looks like.

Mr. LEVIN. So, there is that nexus, is there not? I think there is—in terms of why there should be a Federal interest. Also, the amount of funds that the States have available also affect what they do about eligibility, for example, right?

Mr. BISHOP. Well, they can make eligibility decisions based on how much money they have to pay out in benefits, potentially.

Mr. LEVIN. Look at the question of extended benefits. They don't generally provide that, but that could also affect the issue of whether they are going to have any funds to extend benefits in terms of high unemployment. So, I think there is not only the issue of the integrity of the State funds—if you want to call them that—but there are these linkages to the Federal Government, and another reason I think for there to be concern and action. So, let me ask you this. Is it necessary that there be action? Don't you think it is important that there be action this year?

Mr. BISHOP. Yes. I think that you will find that the Administration will be wanting to work with the Committee on moving something this year with regard to this particular issue.

Mr. LEVIN. When you say working with the Committee, are you going to present some proposals to us?

Mr. BISHOP. I think we plan on doing so, yes.

Mr. LEVIN. When would they be forthcoming?

Mr. BISHOP. Again, we have legislative language that we have been working on in the Department of Labor. We believe that we could present the Committee with legislative language in fairly short order.

Mr. LEVIN. That is really necessary if we are going to act this year, right?

Mr. BISHOP. Yes.

Mr. LEVIN. It is June. It is almost July. Then we are not here in August. Then there is September. So, you would hope in short order to have some proposals here?

Mr. BISHOP. Yes.

Mr. LEVIN. Isn't it true that this is likely to be a continually growing problem?

Mr. BISHOP. Well, as I indicated in the other gentleman's question, we are concerned that this is the kind of problem that has the potential to grow and get bigger.

Mr. LEVIN. It tends to grow as there is economic difficulty?

Mr. BISHOP. Well, we don't have data in the context of—does it seem to occur more during a recessionary period, or not? Anecdotally, one might assume that it has the potential to do so, as folks are looking at the State-level employers, potentially, for lower cost in the UI program.

Mr. LEVIN. There is some evidence that this practice has been growing the last few years?

Mr. BISHOP. Yes. As I said, in the mid-1990s, we had two studies where it was documented as a practice that was just starting. It seems to be a practice that is growing, and we have evidence of certain companies actually promoting the use of this as a way to lower employer taxes.

Mr. LEVIN. That evidence has been publicized?

Mr. BISHOP. It has been documented, yes. I believe there is newspaper articles that talk about it, and I think you will hear, later, some evidence of that happening.

Mr. LEVIN. Thank you.

Chairman HERGER. Thank you. Mr. Bishop, is the real problem with SUTA dumping a lack of State or Federal legislation, or is it broader, and include problems with detection and enforcement?

Mr. BISHOP. Well, I think—and this got to a point that was made earlier—it really is a two-part issue, which I think you have just identified, Mr. Chairman. One of which is, we do believe that it is an issue of tightening the law to say that the practices are clearly not legal. Then, once we do that, it will be incumbent upon the Department of Labor to work very closely with the States to help them be able to put into effect the appropriate enforcement actions, and to be able to monitor and assure that the law is being met.

Chairman HERGER. Thank you. Are there any State performance measures that indicate the number of SUTA dumping enforcement actions taken by States with existing legislation?

Mr. BISHOP. No. We do not have performance measures on that currently. However, this may be something we need to take a look at.

Chairman HERGER. Very good. Thank you. The gentleman from Wisconsin.

Mr. KLECZKA. Thank you, Mr. Chairman. Just a very quick question, Mr. Bishop. Is this a problem that can only be fixed by the Federal Government, and by Federal legislation, or do the States have within their power the ability to respond to this dumping situation?

Mr. BISHOP. Well, the States clearly could pass State legislation. You would have to have 53 State jurisdictions doing so. If all 53 UI jurisdictions—States and territories—did that, they could fix it on their own. Again, we believe that it is an appropriate role of the Federal Government.

Mr. KLECZKA. To foster uniformity throughout the country?

Mr. BISHOP. Yes, correct.

Mr. KLECZKA. This is the place to come?

Mr. BISHOP. Correct.

Mr. KLECZKA. Okay, good. Thank you.

Chairman HERGER. Thank you. Mr. Bishop, the Department of Labor's 2002 Unemployment Insurance Program Letter, UIPL 34–02, alerted States to expanded SUTA dumping activity. What prompted this action, and what response have you gotten from the States?

Mr. BISHOP. Well, again, Mr. Chairman, what prompted the action was more evidence and anecdote concerning this becoming a growing problem. We felt it necessary to alert the States that this is something they need to look at, potentially, to get the ball rolling and legislate at the State level.

What we have seen happen as a result, I think you are going to hear later today—a State like North Carolina, which has taken some action immediately. We have a couple of other States—Texas, Delaware, and California, for example—that have also taken some steps and some action to do that. So, we felt it was important to alert the States of this practice, and also to say that, in the context of what the Department of Labor feels, it is not an appropriate activity to continue to occur.

Chairman HERGER. Thank you very much for your testimony, Mr. Bishop. With that, we call on our second panel today. Robert Cramer, Managing Director of the Office of Special Investigations at the GAO. He is accompanied by Paul Desaulniers, Senior Special Agent in the Office of Special Investigation at GAO. David Clegg, Deputy Chairman for Communications for the North Carolina Employment Security Commission in Raleigh, North Carolina. Carl Camden, President and Chief Operating Officer of Kelly Services, Inc., in Troy, Michigan. Thank you. Mr. Cramer, GAO.

STATEMENT OF ROBERT J. CRAMER, MANAGING DIRECTOR, OFFICE OF SPECIAL INVESTIGATIONS, U.S. GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY PAUL DESAULNIERS, SPECIAL AGENT, OFFICE OF SPECIAL INVESTIGATIONS

Mr. CRAMER. Good afternoon, Chairman Herger, Chairman Houghton, and Members of the Subcommittees. Thank you for the opportunity to appear before you today to discuss the results of the work that we have done pertaining to SUTA dumping. I am accompanied here today by Special Agent Paul Desaulniers, who is our Chief Investigator in this matter.

To obtain an overview of the extent of the SUTA dumping problem, the Office of Special Investigations at GAO did two things. First, we conducted a nationwide survey of State UI administrators. Second, Agent Desaulniers, posing as a business owner who was looking for ways to reduce the State UI tax he pays for his employees, placed telephone calls to four tax planning consultants he identified through the Internet to determine whether and how they promote SUTA dumping techniques.

To summarize our survey results, approximately two-fifths of the administrators indicated that their States are adequately addressing the problem, or that they are not aware of any SUTA dumping problems in their jurisdictions. However, approximately three-fifths of the State administrators informed us that their State laws are

insufficient to deal with SUTA dumping problems, and that enforcement efforts to combat such practices are inadequate.

Administrators in 21 States reported that they have no laws at all specifically addressing this SUTA dumping issue. The remaining 29 State administrators indicated that they do have laws; however, seven of those indicated that their laws are not sufficient.

Additionally, more than half of the 50 administrators who responded to our survey indicated that SUTA dumping practices are or may be resulting in a loss of State unemployment tax revenue in their States. Fourteen States reported that they have identified SUTA dumping cases within the past 3 years with losses from these cases totaling $120 million.

Many administrators added comments to our survey in which they 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 the SUTA dumping issues.

To determine whether and how consulting firms promote SUTA dumping methods, Agent Desaulniers placed telephone calls to four tax planning consultants. Again, he found these all through the Internet. He posed as a construction company owner having 1,000 employees and doing business in four different States. He asked each consultant about the feasibility of switching his employees to another business entity in order to reduce his UI tax payments.

One consultant he spoke with recommended that he spin off part of his company and form a new one to obtain a lower tax rate. The consultant said that as long as the business has good strategies, and there is, quote, "Some kind of substance behind it," the practice is legal. Another consultant suggested moving employees on paper into another type of organization to get a better tax rate. In his words, quote, "It more or less becomes a kind of shell game where you are moving people around periodically to obtain more favorable rates." The consultant stated that this practice is legal. A third consultant told Agent Desaulniers that if he merely switches his employees to a newly created company, the State would transfer the unemployment tax rate of the old company to the new one. So, he suggested that, instead, one should lower the rate by merging the existing company with another business that has a lower tax rate.

The fourth consultant we contacted stated that SUTA dumping is illegal in many States, but is permitted in some States if certain events occur, such as an asset transfer, or the formation of a new business division. This consultant was very cautious, however, about this type of strategy, and indicated little interest in providing SUTA dumping services. Mr. Chairman, that concludes my statement. At this time, Agent Desaulniers will play excerpts from the tapes of two conversations he had with the consultants. Appendix I to the testimony is a transcript of the excerpts he will be playing.

Mr. DESAULNIERS. So, to reiterate, I posed as a construction company owner having 1,000 employees doing business in Maryland, Pennsylvania, Delaware, and New Jersey. I asked each consultant about ways to reduce my UI taxes, and the feasibility of

switching employees to another business entity for that purpose. This is the first consultant I spoke with.

[Tape played.]

Mr. DESAULNIERS. Here is the second consultant that I spoke with.

[Tape played.]

Mr. DESAULNIERS. That concludes the conversations.

Mr. CRAMER. That concludes our presentation. We would be happy to answer any questions that you might have.

[The prepared statement of Mr. Cramer follows:]

Statement of Robert J. Cramer, Managing Director, Office of Special Investigations, U.S. General Accounting Office, accompanied by Paul Desaulniers, Senior Special Agent, Office of Special Investigations, U.S. General Accounting Office

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, including the 50 states, 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, 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.

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[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.

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 discernible 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.

Chairman HERGER. Thank you very much. We will move to our next witness, Mr. David Clegg, Deputy Chairman for Communications for the North Carolina Employment Security Commission in Raleigh, North Carolina. Mr. Clegg.

STATEMENT OF DAVID L. CLEGG, DEPUTY CHAIRMAN, EMPLOYMENT SECURITY COMMISSION OF NORTH CAROLINA, RALEIGH, NORTH CAROLINA

Mr. CLEGG. Chairman Herger, thank you. Chairman Houghton, Members of the Subcommittees, thank you for providing me with the opportunity this afternoon to speak to you——

Chairman HERGER. If you could move the microphone. There you go.

Mr. CLEGG. To talk to you about the significance of State UI Trust Fund solvency. I am proud that North Carolina has taken a leadership role in identifying both statutory and programmatic remedies for this practice, which has the potential to hurt workers and employers who fulfill their roles in our economy in an honorable and legal manner.

If SUTA dumping can exist in North Carolina, it surely must exist in every State. Due to a robust economy and a trust fund balance of over $1.6 billion, North Carolina was able to lower its UI rate for new accounts, and the tax rate for positive rated employers in 1993, 1994, 1995, 1996, and 2000. In 1995, our rate was reduced by 50 percent, and in 1996, all positive rated accounts received a zero tax rate. We boasted a labor market of over 4 million people and 178,000 employers.

So, we know that SUTA dumping is present in North Carolina. The practice arrived contemporaneously with the downturn in North Carolina's economy, and in our dramatic rise in claims for UI assistance. We were told about it by employers shocked when they received literature telling them to do it. Members of the North Carolina General Assembly, whose constituents complained that they were being solicited, told us. We contend that SUTA dumping has always been illegal under North Carolina law, despite the bold statements of a few to the contrary. However, with the recent action of the North Carolina General Assembly, signed into law by Governor Easley, everyone now knows that it is illegal.

We know that SUTA dumping tax shelter schemes have been sold to major corporations operating in North Carolina. We also know that this activity started in at least the third quarter of 2001.

Initially, clear existence of SUTA dumping was uncovered when the Employment Security Commission received a late payment on a voluntary UI tax contribution in January 2002. A taxpayer had set up a limited liability corporation (LLC), transferred a tiny fraction of the company's negative experience rating to that LLC, and then the LLC planned to obtain a zero tax rate the next year by making a small voluntary contribution. Voluntary payments are allowed by statutes, and employers can use them to lower a UI tax rate. However, the payments have to be made on time.

The parent corporation could have lowered its tax rate to zero, but the voluntary contribution would have been in excess of $4 million. By creating the LLC only with employees, the LLC needed only to pay $30,000 to obtain its new rate. The next year, the par-

ent corporation would have reported wages of all of its over 1,500 workers to the LLC with the zero rate.

The Employment Security Commission issued public statements and a public tax alert. We were aware of the issue through the Department of Labor program letter. Constituents alerted both Members of the General Assembly and the Employment Security Commission, and the General Assembly took quick action, which was a collaborative effort among legislators, the Employment Security Commission, certified public accounts, and employer associations.

Our law became effective May 20th. It makes it a felony for any person to attempt to SUTA dump. The law is premised on a continuity of control issue, and carries its stiffest penalties against employers with more than 10 employees owing more than $2,000, and/or having a negative experience rating of more than $5,000. This law does clearly identify that there is an activity called UI contribution tax return preparer, and establishes liability for that illegal preparation also. The felonious components of that bill provide for incarceration from six to 8 months.

It is too early to tell what our final dollar and liability amount will be for SUTA dumping. We recently advised an accounting firm that they had failed to reveal it in their independent audit. On other fronts, we have received an $18,000 assessment. We have seen protests of over $400,000 be dropped. We have seen taxpayers reassume liability for over $4 million. In the next 30 days, we will begin on-site investigations at 10 taxpayer offices where we have reason to believe this has occurred with liability of over $2 million.

North Carolina has developed a real-time computerized tax analysis program that does assist us in detecting SUTA dumping. It looks at voluntary contribution rates, it looks at the movement of work forces, and it looks at issues of the lack of filing from corporate taxpayers. Thank you very much for this opportunity. I look forward to your questions.

[The prepared statement of Mr. Clegg follows:]

Statement of David L. Clegg, Deputy Chairman, Employment Security Commission of North Carolina, Raleigh, North Carolina

Chairman Houghton and Chairman Herger, thank you for providing me with the opportunity to speak today about the issue of state unemployment insurance tax rate manipulation and its significance to state unemployment insurance trust fund solvency. I am proud that North Carolina has taken a leadership role in identifying both statutory and programmatic remedies for this practice that has the potential to hurt the workers and employers who fulfill their roles in our economy in an honorable and legal manner. At the North Carolina Employment Security Commission, we say that ESC stands for "Economic Stability in the Community," and the existence of SUTA dumping potentially undermines ESC's mission of providing critically importance transitional assistance to workers discovering new career paths in a technologically sophisticated and diverse economy.

If SUTA dumping can exist in North Carolina, it surely must exist in every state. Due to a robust economy and a trust fund balance of over $1.6 billion, North Carolina was able to lower its unemployment insurance (UI) rate for new accounts and the tax rate for positive rated employers in 1993, 1994, 1995, 1996 and 2000. In 1995, the rate was reduced by fifty percent, and in 1996 all positive rated accounts received a zero tax rate. North Carolina boasted a labor market of over 4 million people and 178,000 employers. If SUTA dumping exists in this progressive economic climate, it must exist in less robust economies and in states with less attractive tax rate structures. Even today, as North Carolina's fifty percent UI tax rate discount is discontinued, it has the fourth lowest UI tax rate in the nation. (Exhibit 1)

We know that SUTA dumping is present in North Carolina. The practice arrived contemporaneously with the downturn in North Carolina's economy and the dra-

matic rise in claims for UI assistance. (Exhibit 2) We were told about it by employers shocked when they received literature telling them to do it. Members of the North Carolina General Assembly whose constituents complained that they were being solicited told us. We contend that SUTA dumping has always has been illegal under North Carolina law despite the bold statements of a few to the contrary. With recent action by the North Carolina General Assembly as signed into law by Governor Easley, everyone now knows it is illegal. Millions of tax dollars are at risk through the use of unlawful UI tax schemes. We know that SUTA dumping tax shelter schemes have been sold to major corporations operating in North Carolina. This activity started, at least, in 2001.

The Employment Security Commission of North Carolina (NCESC) levies and collects unemployment taxes, maintains wage records, processes benefit claims, and assigns tax charges to employer's accounts. NCESC issues over 200,000 initial decisions on benefit claims affecting claimants and employers. It holds over 40,000 hearings and has internal appeals procedures as well as continuous civil litigation. ESC has a statewide staff of 90 auditors who conduct forensic audits and often depend on criminal warrants against employers who fail to file tax returns. Ten years ago, the Commission adopted a system of employer self-application. One result of voluntary compliance was more time for auditors to conduct intense scrutiny of problem accounts.

A key feature of UI law is that employers must pay the tax benefit costs for their own workforce. This is done by using the experience rating system in which an employer's tax account is charged for the costs of claims paid out to former employees—unemployed through no fault of their own.

Basically, SUTA dumping occurs in the following fashion: A corporation, (First Corporation) decides its does not want to pay the high unemployment insurance taxes. Those high taxes were caused by the corporation's own history of high employee turnover and large unemployment claims. To avoid the tax, First Corporation sets up new corporation (Spin-off Corporation.)

Spin-off Corporation files for a new UI account from NCESC. Spin-off Corporation claims to be a brand new employer entitled to a lower new employer UI tax rate. Spin-off Corporation does not disclose that First Corporation controls it. NCESC has no reason to assume that Spin-off Corporation is not a new taxpayer. In Spin-off Corporation's application for a new employer tax identification number, Spin-off Corporation does not admit that First Corporation controls it.

Once Spin-off Corporation is established with NCESC, First Corporation waits until the next calendar quarter to shift the reporting of all its employees to Spin-off Corporation at the lower tax rate. First Corporation hopes that NCESC won't notice the pattern of transfer. First Corporation retains control of Spin-off Corporation. By retaining legal control or ownership of Spin-off Corporation, First Corporation maintains its common law employer-employee relationship with every employee whose wages were misreported.

It is clear that First Corporation is entitled to establish any number of business entities it chooses. They can be partnerships, S corporations, or L.L.C.'s (Limited Liability Corporations). Those businesses can do anything legal, but they can't escape the fact that First Corporation has to pay UI taxes on all the employees that it controls. As long as First Corporation controls Spin-off Corporation, First Corporation retains the responsibility to pay UI taxes on its own workforce. Until First Corporation sells or releases control of Spin-off Corporation, First Corporation retains its tax liability.

Several economic and financial measures confirm that First Corporation is the taxable employer as defined by North Carolina law. First Corporation's workforce is now performing the same work for Spin-off Corporation at the same locations. First Corporation has not sold or given up its benefit from and ultimate control of Spin-off Corporation's workers. First Corporation treats the revenue from Spin-off Corporation's workers and operations as its own. Spin-off Corporation's profits and losses are reported on First Corporation's income tax returns by treating Spin-off Corporation as a disregarded entity under IRS laws. First Corporation retains the legal right to control and benefit from Spin-off Corporation's profit and loss even if First Corporation does not directly exercise such rights. Spin-off Corporation may have the same corporate officers, physical facilities, payroll and human resources structure. Inaccurate, misleading and incomplete information was supplied to NCESC in order (1) to obtain a lower tax rate than allowed by law, (2) to pay a less tax than owed, and (3) to write off many dollars of accumulated tax liability.

NCESC is fortunate to have a dedicated UI tax staff committed to full compliance under law. Initially, clear existence of SUTA dumping was uncovered when ESC received a late payment on a voluntary UI tax contribution in January 2002. A taxpayer had set up an L.L.C. and transferred a tiny fraction of the company's negative

experience rating account to the L.L.C. The L.L.C. planned to obtain a zero tax rate for the next year by making a small voluntary UI tax payment. Voluntary payments are allowed by statute and employers can lower a UI tax rate by doing so. However, the payments have to be made on time. The parent corporation could have lowered its own tax rate to zero, but the voluntary contribution would have been nearly $4 million. By creating the L.L.C. with only a few employees and a tiny portion of the parent corporation's tax liability, the L.L.C. only needed to pay $30,000 to obtain the low rate. The next year, the parent corporation would have reported the wages of all its over 1,500 workers on the tax return of the L.C.C. with the zero tax rate.

ESC issued public statements and a public tax alert about SUTA dumping. (Exhibit 3) Press releases and the Commission's own website (ncesc.com) were used to warn of the potential criminal liability for SUTA dumping. Major news outlets in North Carolina were conducting independent investigations of SUTA dumping based on the August, 2002 (revised December, 2002) U.S. Department of Labor Program Letter and responded to NCESC's request to raise public awareness on this issue. Constituent concerns alerted members of the North Carolina General Assembly to the need for statutory action about SUTA dumping. The North Carolina SUTA dumping bill became a collaborative effort among legislators, ESC, and certified public account and employer associations.

North Carolina's SUTA dumping bill became law on May 20, 2003. (Exhibit 4) The law makes it a felony for any person to attempt to SUTA dump or for a UI tax advisor to aid or abet SUTA dumping. The law is premised upon continuity of control and carries its stiffest penalties against employers with more than 10 employees, owing more than $2,000.00, and/or having a negative experience rating of more than $5,000.00. This law identifies that there is an activity called "UI contribution tax return preparer" and establishes liability for illegal preparation. The presumptive sentence for felonious violation of the law is 6 months incarceration up to 8 months for aggravated circumstances. Uncapped fines may be imposed in the discretion of the court. At the present time, the Commission is considering the possibility of joint investigations with nearby states that are victimized by multi-state SUTA dumping schemes.

It is too early to tell what the final dollar and liability count will be for SUTA dumping. NCESC recently advised an accounting firm that it had failed to uncover SUTA dumping when it performed an independent audit. The evidence in that case shows SUTA dumping in November 2001. On other fronts, NCESC received an $18,000.00 assessment to cover a SUTA dump UI tax delinquency. Taxpayers have dropped protests seeking the return of over $400,000.00 in UI taxes. Other taxpayers have re-assumed tax liability of $4 million. Within the next 30 days, NCESC will begin on-site investigations at 10 taxpayer's offices with UI tax liability of over $2 million. Inquiries arrive at NCESC nearly every day seeking to address this issue through negotiation and payment. NCESC has developed a real time, computerized, tax analysis program to detect SUTA dumping. It includes, in part, a revised voluntary contribution report that detects lowered rates beyond ordinary parameters, a management report charting the movement of work forces from overdrawn negative accounts to newly established positive accounts, and a management report that shows a lack of filing from corporate taxpayers.

The vast majority of North Carolina's 178,000 employers is honest and willingly pays their taxes. A century ago a distinguished corporate lawyer became Secretary of War, then Secretary of State, and then an U.S. Senator. He said, "About half the practice of a decent lawyer consists in telling would-be clients that they are damned fools and should stop." I would hope that those who attempt to induce others to illegally manipulate UI tax laws would heed Elihu Root's advice.

EXHIBIT 1

Unemployment Insurance Trust Fund:
Recent Changes in North Carolina Employment Security Law

Financial impacts of changes in ESC law were calculated for 1995 forward. However, some changes made in 1993 and 1994 are provided because of their use of the '50 percent rule' or very similar rules.

Changes effective January 1, 1993

1. The standard contribution rate for new accounts reduced from 2.7 percent to 2.25 percent.
2. The contribution rate for positive-rated accounts was reduced by 30 percent, beginning April 1, 1993.

Changes effective January 1, 1994

1. The standard contribution rate for new accounts reduced from 2.25 percent to 1.8 percent.
2. The rate for positive-rated accounts was reduced by 50 percent in any year in which the trust fund balance on the previous computation date was $800 million or more.

Changes effective January 1, 1995

1. The rate for positive-rated accounts was reduced by 50 percent in any year in which the trust fund balance on the previous computation date was $800 million or more and fund ratio was less than 5.0 percent. The rate for positive-rated accounts was reduced by 60 percent in any year in which the trust fund balance on the previous computation date was $800 million or more and fund ratio was 5.0 percent or more.
2. Accounts with a reserve ratio of 5.0 percent or more receive a zero rate. (Prior to this change, the lowest rate was 0.01 percent, and it applied to accounts with a credit ratio of 6.2 percent or more.)
3. The method of calculating taxable wages was changed to reduce taxable wages as a share of total wages. The taxable wage base is the greater of the federally required taxable wage base ($7,000) or the average annual insured wage multiplied by 50 percent, and rounded to the nearest multiple of $100. The above multiplier was reduced from 60 percent to 50 percent.

Changes effective January 1, 1996

1. All positive-rated accounts received a one-time zero rate for calendar year 1996.
2. The standard contribution rate for new accounts reduced from 1.8 percent to 1.2 percent.

Changes effective January 1, 2000

1. All UI contribution rates were reduced by 20 percent for calendar years 2000 and 2001.
2. All UI accounts paid a training contribution of 20 percent of the (reduced) UI rate for calendar years 2000 and 2001. (The maximum combined UI plus training rate was set at 5.7 percent. Thus if 20% of the UI rate would result in a combined rate above 5.7 percent, then that account paid a training rate that, when combined with the UI rate, would not exceed 5.7 percent.)
3. Accounts with a reserve ratio of 4.0 percent or more received a zero rate. (Prior to this change, accounts with a reserve ratio of 5.0 percent or more received a zero rate). This was a permanent change; it has no sunset provision.

Changes effective January 1, 2002

1. All UI contribution rates are reduced by 20 percent and all UI accounts pay a 20 percent training tax (based on the reduced UI rate) if the computation balance in the prior year is more than $900 million and the total unemployment rate is not above 4.3 percent at any time over the 12 months prior to the computation date. If the latter conditions are not met, then the training tax does not apply and all accounts pay their regular UI contribution rates. This is in effect through December 31, 2005. (The maximum combined UI plus training rate was set at 5.7 percent. Thus if 20% of the UI rate would result in a combined rate above 5.7 percent, then that account paid a training rate that, when combined with the UI rate, would not exceed 5.7 percent.)

EXHIBIT 2

Employment Security Commission of North Carolina
UI Tax Alert
For Immediate Release: February 24, 2003
State Unemployment Tax Avoidance (SUTA Dumping)

The Employment Security Commission (ESC) has become increasingly aware of the practice of State Unemployment Tax Avoidance (also called "SUTA dumping") in North Carolina. The agency has also learned that certain tax advisory companies are promoting this activity as a way of gaining business by promising potential clients reduced expenses and increased profits.

The ESC will actively pursue and prosecute employers engaged in this activity and has the authority to subpoena records and individuals in its investigations. The

maximum punishment is a fine imposed in the court's discretion and 45 days confinement.

SUTA dumping is a practice of employing units to create new business entities, transfer employees—and, in some cases, a part of the organization, trade or business—to deliberately avoid an unemployment insurance (UI) tax rate and deficit in its experience rating account. The burden of the deficit is then shifted to all other employers.

Employers engaged in this activity knowingly misrepresent the purpose of the new business entity on quarterly UI tax returns and reports. It is illegal under ESC statutes to knowingly make false statements and omit material facts on UI tax documents in order to reduce unemployment taxes. This practice is in violation of N.C. G.S. 96–18(b), with a two-year statute of limitations:

> **§ 96–18. Penalties.**
> (b) Any employing unit or any officer or agent of an employing unit or any other person who makes a false statement or representation, knowing it to be false, or who knowingly fails to disclose a material fact to prevent or reduce the payment of benefits to any individual entitled thereto, or to avoid becoming or remaining subject hereto or to avoid or reduce any contributions or other payment required from an employing unit under this Chapter, or who willfully fails or refuses to furnish any reports required hereunder, or to produce or permit the inspection or copying of records as required hereunder, shall be guilty of a Class 1 misdemeanor; and each such false statement or representation or failure to disclose a material fact, and each day of such failure or refusal shall constitute a separate offense.

The ESC is developing a real-time tax analysis program to review UI tax account activity in order to detect signs and patterns of fraud. The agency's tax fraud detection efforts will target both active and inactive UI accounts.

Employers can help protect the integrity of the UI Trust Fund and keep UI tax rates at minimum levels by being informed about this activity. Information may be reported to Anne Coomer, ESC Tax Status Manager, at 919–733–7156, or Ted Brinn, ESC Field Tax Operations Manager, at 919–733–7396. Any information provided and the source of the information will be kept confidential.

EXHIBIT 3

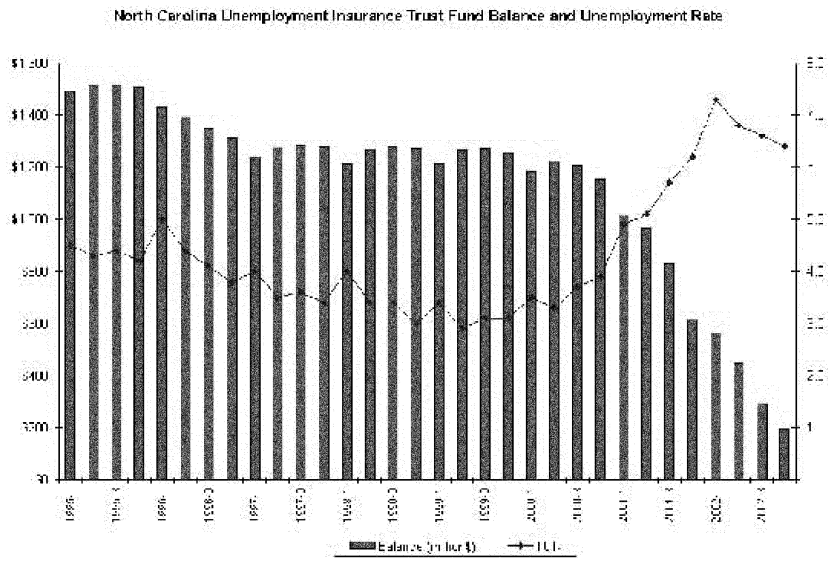

EXHIBIT 4

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2003
SESSION LAW 2003–67
SENATE BILL 326

AN ACT TO CLARIFY THE LAW ON CHANGING THE FORMS OF BUSINESSES FOR UNEMPLOYMENT INSURANCE TAX PURPOSES AND TO INCREASE PENALTIES, SO AS TO DETER THE PRACTICE OF STATE UNEMPLOYMENT TAX AVOIDANCE (SUTA DUMPING).

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 96–9(c)(4) is amended by adding a new sub-subdivision to read:

"a1. A new employing unit shall not be assigned a discrete employer number 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. That new employing unit shall continue to be the same employer for the purposes of this Chapter as before the acquisition or change in form. As used in this sub-subdivision:

1. 'Control of the 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.

2. A 'continuity of control' will exist if one or more persons, entities, or other organizations controlling the business enterprise remain in control of the business enterprise after an acquisition or change in form. Evidence of continuity of control shall include, but not be limited to, changes of an individual proprietorship to a corporation, partnership, limited liability company, association, or estate; a partnership to an individual proprietorship, corporation, limited liability company, association, estate, or the addition, deletion, or change of partners; a limited liability company to an individual proprietorship, partnership, corporation, association, estate, or to another limited liability company; a corporation to an individual proprietorship partnership, limited liability company, association, estate, or to another corporation or from any form to another form. This sub-subdivision shall not modify the provisions of G.S. 96–10(d)—Collections of Contributions Upon Transfer or Cessation of Business.

SECTION 2. G.S. 96–18 is amended by adding a new subsection to read:

"(b1) Except as provided in this subsection, the penalties and other provisions in subdivisions (6), (7), (9a), and (11) of G.S. 105–236 apply to unemployment insurance contributions under this Chapter to the same extent that they apply to taxes as defined in G.S. 105–228.90(b)(7). The Commission has the same powers under those subdivisions with respect to unemployment insurance contributions as does the Secretary of Revenue with respect to taxes as defined in G.S. 105–228.90(b)(7).

G.S. 105–236(9a) applies to a 'contribution tax return preparer' to the same extent as it applies to an income tax preparer. As used in this subsection, a 'contribution tax return preparer' is a person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this Chapter or any claim for refund of tax imposed by this Chapter. For purposes of this definition, the completion of a substantial portion of a return or claim for refund is treated as the preparation of the return or claim for refund. The term does not include a person merely because the person (i) furnishes typing, reproducing, or other mechanical assistance, (ii) prepares a return or claim for refund of the employer, or an officer or employee of the employer, by whom the person is regularly and continuously employed, (iii) prepares as a fiduciary a return or claim for refund for any person, or (iv) represents a taxpayer in a hearing regarding a proposed assessment.

The penalty in G.S. 105–236(7) applies with respect to unemployment insurance contributions under this Chapter only when one of the following circumstances exist in connection with the violation:

(1) Any employing units employing more than 10 employees.

(2) A contribution of more than two thousand dollars ($2,000) has not been paid.

(3) An experience rating account balance is more than five thousand dollars ($5,000) overdrawn."

SECTION 3. Section 2 of this act becomes effective December 1, 2003. The remainder of this act is effective when this act becomes law. In the General Assembly read three times and ratified this the 15th day of May, 2003.

s/ Marc Basnight
President Pro Tempore of the Senate
s/ Richard T. Morgan
Speaker of the House of Representatives
s/ Michael F. Easley
Governor

Chairman HERGER. Thank you, Mr. Clegg. Now we will hear from Carl Camden, President and Chief Operating Officer of Kelly Services, Inc., Troy, Michigan. Mr. Camden.

STATEMENT OF CARL CAMDEN, PRESIDENT AND CHIEF OPERATING OFFICER, KELLY SERVICES, INC., TROY, MICHIGAN

Mr. CAMDEN. Thank you, Chairman Herger, Chairman Houghton. I am Carl Camden, President and Chief Operating Officer of Kelly Services, Inc., and I really do appreciate the opportunity to come here and talk with you all. This is also a very critical issue from Kelly Services, Inc.'s perspective. For a quick profile on Kelly Services, Inc., we were founded in 1946. We are the second largest staffing company in the United States. We operate in all 50 States. We have 2,400 offices, but, most germane to today's presentation, we employ, in the course of a year in the United States, nearly 700,000 people.

The practice of SUTA dumping, while it may have become more severe now, has been increasing slowly from the middle 1990s until now. In 1994, Kelly Services, Inc. received its first solicitation. The accounting firm who sent it to us asked us to keep it quiet because not very many people knew about it. Every year, as it has gone on, we receive more and more solicitations. Today, I will tell you that there is no large accounting firm who has not solicited Kelly Services, Inc. to engage in SUTA dumping, and you can add several dozen law firms and tax consultants. Perhaps what bothered me the most is last year, when one of my officers rejected the offer of SUTA dumping, and he received a very angry letter from the accounting firm which said, does the president of your company know you are doing this? You are betraying your fiduciary responsibility to your shareholders by costing your company several million dollars in profits that they could obtain if they would engage in this practice.

It is rare, perhaps, to hear a businessperson speak in favor of a tax, but we at Kelly Services, Inc. believe that the SUTA tax system is intrinsically fair. If you control your tax, you control your unemployment experience, you keep your workers employed, you have a lower experience rate, then you pay less taxes. If you are unable to keep your workers employed, and you have a high experience rate, then you pay more taxes. Taxes go up. The taxes go down the better you do; they go up the worse you do. We under-

stand that in an economic cycle, you will perform worse as the unemployment rate goes up, and you will pay more. Over the last two years—2003, and what we project into 2004—Kelly Services, Inc.'s contributions that we were required to pay into the State UI are going up by over $10 million a year. We are not complaining about that. We also know they will go down in the future as our experience goes down and the unemployment problem becomes less.

What irks me tremendously, though, is that in addition to the $10 million that is going up based on our own experience, we are also paying $1 to $2 million subsidizing people who are, in fact, engaged in SUTA dumping. That bothers me, and what really is a problem is that I face a competitive disadvantage as I compete against companies who engage in SUTA dumping and we don't. Their cost of service is less than ours—and it is significantly less. So, those of us who are trying to do what, in fact, is both legal and ethical, find ourselves at a competitive disadvantage as we compete against firms who engage in what in many States is, in fact, a legal but, we believe, unethical practice of SUTA dumping.

Much of what you have heard today, I could duplicate—but I won't. I would like to address one particular issue, and that is the issue of urgency. I believe, in fact, that SUTA dumping is going to increase. It is in the process of increasing. If I judge it by nothing more than the rate of solicitations that we receive, and the number of references those companies are able to provide, I can tell you that the participation rate is high.

As I dissect the rates that our competitors charge, it is easy to detect evidence of SUTA dumping. As the unemployment rate continues to increase, or even stay where it is, you can expect the contributions companies are to pay, and the unemployment tax to lag that by 1 or 2 years. In other words, the potential payback from SUTA dumping is going to increase over the next 1 to 2 years. While you have heard a number of $114 million, let me tell you that if Kelly Services, Inc. was willing to aggressively pursue SUTA dumping, taking everything all the way to the edge, we alone could save between $20 and $30 million dollars. So, $110 million strikes me as a low estimate. More importantly, I am asking you to consider the potential damage that is going to be done over the next 1 to 2 years if we do not step forward and halt the abuse, and make it clear that while it may currently be a legal practice, it is not a practice that should be allowed to continue. We very much believe that there is a set of small actions that could be taken that would have a significant impact on reducing this.

We do believe that States should be required to revise their laws to require mandatory transfer of unemployment experience for mergers, acquisitions, transfers of trades, or business. Yes, there is always a legitimate—there are many legitimate reasons to set up businesses, to break apart divisions, but there is never a legitimate reason not to transfer the work experience that those employees had before they moved into the new unit. We encourage the Department of Labor to develop tools and training, because I think the States are willing, but the knowledge is weak as to how you go about detecting and enforcing it. We would like to see appropriate enforcement by the States of the laws that are already on the books.

Let me conclude with a paragraph from one of the last letters of solicitation that we received where somebody was asking us to engage in SUTA dumping in the State of California—and of course they were willing to do so for a fee. It is important to note that, in accordance with section 135.1 of the California Unemployment Insurance Code, the State could assert a continuity of control and ownership and thereby treat Kelly Services, Inc. and the new company as a single employer. However, it has been our experience that the State will not impose this section of the law. We have to enforce the laws we have. We need to require the mandatory transfer of experience, and we need to provide the States with the tools they need to take care of the problem. Thank you, Mr. Chairman.

[The prepared statement of Mr. Camden follows:]

Statement of Carl Camden, President and Chief Operating Officer, Kelly Services, Inc., Troy, Michigan

Good afternoon Chairman Herger, and Chairman Houghton, and members of the Subcommittees on Oversight and Human Resources. I appreciate the opportunity to speak with you today regarding our shared goal of a strong, viable and sustainable unemployment insurance program.

I am Carl Camden, President and Chief Operating Officer of Kelly Services. For those who may not be familiar with Kelly, the company was founded in 1946 and today is the second largest staffing services company in the United States. Our employees work in 50 states and in 26 nations. We own and operate our own branch network of 2,400 offices. Last year Kelly employed nearly 700,000 people.

Kelly Services recognizes the importance of an effective unemployment insurance system for workers, employers, and the economy as a whole. We applaud today's hearings to examine ways to improve and protect the system and to serve the needs of the unemployed.

Employers pay unemployment taxes at rates commensurate with claims activities by their employees. Employers with high unemployment activity are assigned higher unemployment tax rates, and employers with lower activity pay less. This fundamental principle—called experience rating—has worked well for years, but is now being undermined. A growing number of employers are engaged in tax avoidance schemes designed to disguise their claims experience. This practice, known as SUTA dumping, is a threat to the integrity and health of our unemployment system. The practice harms both workers and employers who play by the rules.

Workers are harmed because this questionable practice eliminates the incentive for employers to keep employees working—they can escape the financial harm that otherwise comes with laying off workers. State trust funds are depleted, taking away the flexibility to even consider benefit or eligibility changes.

Employers are harmed because they must pay more to make up for the taxes that other companies avoided through SUTA dumping.

It is important that Congress act promptly to solve this problem. The long-term labor market trends that make this practice attractive to some employers will continue—and accelerate. The adverse impact on the financial health of the unemployment insurance system will also continue to grow significantly.

As the proportion of service workers in the economy continues to increase—they comprised 16% of the workforce in 1960, and grew to 36% by 2000—so will the temptation to engage in SUTA dumping. This is because payroll taxes are a large and important part of a service company's total tax burden.

Because of the economic slow down, unemployment rates have risen significantly. Therefore, it is important to realize that the most opportune time for SUTA dumping is following a slowdown, when unemployment tax rates are high, as they are now and will be for several years.

As you know, state unemployment trust funds are under significant stress with the states of Illinois, Minnesota, Missouri, New York, North Carolina and Texas already borrowing from Federal accounts. California and Massachusetts will likely need to borrow before the end of the year.

In the staffing industry, people are our business. Therefore, payroll is our largest single cost. In 2002, Kelly's total U.S. payroll was $2.1 billion. Our taxable payroll was $1.4 billion, or 66% of our total payroll. If Kelly can reduce our unemployment tax rate by just one tenth of a percent, we can save $1.4 million. Small rate changes have a big impact.

Because it is such a significant cost, we manage our unemployment compensation activities closely. We work hard to return employees to work as quickly as possible when economic conditions force layoffs. We provide training to upgrade employees' skills and increase the number of jobs they qualify for. We contest claims that we think are without merit.

The staffing industry has been particularly hard hit by the current state of the economy. In 2003, Kelly's unemployment taxes increased by $12 million. But this is how the system is supposed to work. Tax rates increase following periods of high claims activity. On top of the 2003 increase, we estimate an additional increase for 2004 of $14 million. Through a systematic SUTA dumping program, we could have avoided the entire $26 million dollar increase. These are the kinds of increases that some companies have avoided through SUTA dumping.

These numbers are certainly large enough to get attention. Therefore, it is easy to understand why SUTA dumping is very tempting for labor-intensive organizations. I assure you that the numbers are significant enough to impact the competitive balance in the market place.

Kelly and the other companies who have said no to SUTA dumping are faced with two basic choices.

- We can ignore the issue, and allow a questionable practice to continue to threaten our competitiveness.
- Or, we can seek appropriate changes to eliminate SUTA dumping, and to protect and preserve the unemployment insurance system.

At Kelly Services, we choose the latter. We therefore urge Congress to act quickly to protect the integrity of the experience rating principle. We are suggesting that Congress:

- Require that state laws be revised to require the mandatory transfer of experience for mergers, acquisitions, and transfers of trade or business, regardless of the ostensible reason for the transaction.
- Direct the Department of Labor to develop tools and provide funding to train state agencies to detect the practice.
- Require appropriate enforcement by the states, of laws already on the books.

Chairman Herger, Chairman Houghton, we appreciate the work of your committees, the work of the Department of Labor, and of the state of North Carolina—and other states—on this important issue. Thank you for the opportunity to appear today. We look forward to working with you in any way we can.

Chairman HERGER. Thank you, Mr. Camden. Chairman Houghton to inquire.

Chairman HOUGHTON. I think we all agree that this is not a great practice, and we ought to try to curtail it. I guess the issue that worries me is how far the Federal Government should go on something like this. If I understand it correctly, if you are in compliance in terms of the UI, it comes to about 0.8 percent of payroll—but if you are not in compliance, the tax jumps up to 6.2 percent of payroll.

Also, it is the testimony of Mr. Clegg that you can get up to 6 months or 8 months for aggravated circumstances—all sorts of penalties that are already existing there. So, what can the Federal Government do to superimpose its will, its might, its discipline, on this whole system, which seems to me is just being violated but the structure that is in place? Maybe I am wrong. Maybe you can explain.

Mr. CAMDEN. I will take a first pass at it, although I find myself an unlikely character to be arguing for a larger Federal role in any lives. It is not my particular political bent. Ultimately, though, a failure at the State level requires the Federal Government to backstop the failure. Yes, three States have currently borrowed. We anticipate at Kelly Services, Inc. that the number is ac-

tually going to be closer to eight States by the end of the year, and of those eight small States, perhaps we wouldn't mind.

Let me go through the list of States that the Federal Government can expect borrowing from before this year is over: Illinois, Minnesota, Missouri, New York, North Carolina, and perhaps Texas, California, and Massachusetts. These are not small States with small payrolls. While, if we leave it to the State issue, we ultimately leave it to the Federal Government to hold the bag for the borrowings that take place.

Second, you already have current law that requires the Federal Government to set the standards by which the States act. This issue of a mandatory transfer of experience has not been established as a principle by which the States need to behave—by which the States need to enact legislation. That principle needs to take place, and it needs to be enforced at the local level.

Finally, the provision of tools—because ultimately, enforcement does take place at the State level. The provision of tools, the provision of training, enables the States to carry out the actions that I think we all expect them to do. Do you have a different perspective?

Mr. CLEGG. Yes, thank you. I am certainly not one who is going to argue for overreaching Federal interference in State issues either. However, we do have, and currently function as a State employment security agency under Federal conformity and compliance issues, which do establish a basic umbrella of consistency across the Nation.

My overriding concern with the issue of SUTA dumping, if it is completely left at the States—if I thought every State would go adopt the law that North Carolina has just passed, I would sleep well. I don't think that would happen, and therefore I don't think we need to get into a situation where people will SUTA shop and deal with multi-state entities in States with less severe penalties for SUTA dumping. So, I think that we need to look at it in the larger umbrella context as a conformity and compliance issue, but leave the specifics to the State, as we have in so many other benefit areas.

Chairman HOUGHTON. Would you like to answer?

Mr. DESAULNIERS. I would like to point out the results of our survey, indicating that although there are States such as North Carolina which are moving aggressively in this area, three-fifths of the State administrators indicated to us that, either they had no laws dealing with this issue, or that their laws were inadequate. So, yes, there are some States that are handling it well, but three-fifths of the State administrators report that their States are not addressing this issue adequately.

Mr. CAMDEN. For a tax evasion scheme that began to appear in the mid-1990s and has picked up steam today, to have only one State that we are able to bring forward today as a witness, argues for the need for a more centralized, collective, and fast response.

Chairman HOUGHTON. Yes. If I understand it, what you are saying is the Federal Government should pass the law to make sure that the States have the proper features, and also enforce those laws—not to superimpose a Federal law on it so as to encourage the States. Thank you very much, Mr. Chairman.

Chairman HERGER. Thank you. The Ranking Member, Mr. Cardin, from Maryland, to inquire.

Mr. CARDIN. Thank you, Mr. Chairman. Mr. Cramer, I guess after listening to all four of your testimonies here, I am convinced by the statement of Mr. Clegg that if SUTA dumping can exist in North Carolina, it surely must exist in every State. I am concerned that—as Mr. Camden has indicated—there could be a $20 million hit on one company alone, Kelly Services, Inc., that when you get two-fifths of our States saying they have adequate laws or enforcement, I question whether that, in fact, is true.

Mr. DESAULNIERS. The two-fifths comprises both those who believe that efforts are adequate, as well as those who are not aware of, or may not be aware of, the extent of the SUTA dumping practice in their States. So, it is a——

Mr. CARDIN. In fact, they are the ones worrying me the most, because they are the administrators who believe they don't have a problem when in fact they do have a problem. They are not looking at what is probably happening within their States. So, I really do think that we don't know the extent of the problem, but that it is clearly going to continue to grow unless we have a national policy.

Now, I don't disagree with Chairman Houghton. This is a State-administered program, so we have to rely upon the States to enforce their laws. However, there has got to be a clear message nationally that we won't tolerate this type of action, because it won't take long for Mr. Camden to get in a position where he will have no choice but to explore this practice if his competitors are doing it. I would be curious as to what impact you think this may have on competition. If you continue to pay the extra, perhaps, $20 million, and a competitor doesn't pay that $20 million, it seems to me you can't do that for too long in too many different categories.

Mr. CAMDEN. I ask myself that question every now and then also. There are traditional responses. We work very hard at training, upgrading our employees, and making them more employable. We are very fast at trying to get them employed at a temporary staffing firm. We are aggressive at understanding when assignments are going to end, and reassigning. Through what I view as just good, solid business practices, we have managed to keep our unemployment experience lower than most of our competitors, and so SUTA dumping hasn't put us at as much of a competitive disadvantage as we have experienced in the last year or two.

I have a chief executive officer who talks to our management team about what he calls the Wall Street Journal test. Which is, he doesn't want to hear about if something is legal or not; he wants to hear that, if it is on the front page of the Wall Street Journal, how are we going to feel about having to explain it to a reporter——

Mr. CARDIN. That sounds like a Member of Congress.

Mr. CAMDEN. I have to tell you, it would be hard for me to explain to a reporter why it is that we would engage in that practice. We will continue to not engage in SUTA dumping, but we will be aggressive at talking to you all here, talking to others, and doing what we can to bring about—again, rare for me to say—the active enforcement of what we think is, intrinsically, a fair tax.

Mr. CARDIN. It is nice to see there are such things as corporate ethics these days. That is good to hear from you. Mr. Clegg, I am curious as to what response you are receiving from the business community in North Carolina. Are you getting support? Are there companies that are a little bit nervous about what you are doing?

Mr. CLEGG. North Carolina has about 178,000 employers, and many of them are represented by two major business lobbying groups in North Carolina—both of whom joined in support of this piece of legislation. I think what Mr. Camden says is very clear. The vast majority of employers do not want their experience ratings skewed by the actions of some of the folks.

The issue of the trust fund in North Carolina had not been an issue for many, many years because we had about $1.6 billion and very low unemployment, and all of a sudden we had 6.4-percent unemployment and the trust fund was nearly empty. Everyone's UI tax rate is now an issue of discussion within the business community, and the Certified Public Accountants Association, plus the major business lobby promotion associations in North Carolina, joined with us in very positive testimony before both the North Carolina House, and the North Carolina Senate as this bill made its way through the General Assembly.

Mr. CARDIN. Again, let me thank all of you for your testimony. That is certainly very helpful.

Chairman HERGER. Thank you very much. Mr. Clegg, I want to join in commending your State, North Carolina, for very aggressively going after this which is obvious, and appears to be becoming a growing problem. I also commend your business community for supporting you. Mr. Camden, I have to particularly commend you and your company, Kelly Services, Inc., for taking the strong ethical stand that you have.

The purpose of this hearing today is to, first of all, identify if there is a problem and what that problem is, one; and then, two, to move forward and identify what it is we need to do as a Congress—what we can do, what would be the most effective way to alleviate this problem. Mr. Camden, if you could tell me, in your opinion, what are the prime issues that need to be addressed to prevent and stop SUTA dumping?

Mr. CAMDEN. I think the critical issue is the transfer of experience, and we need to not let that issue get clouded up with the legitimate needs of countries to divide businesses. We have a health care business. We provide scientists, engineers—and all of them we have in separate businesses, because they have very different business practices.

The issue is not that you can form companies, or even necessarily combine companies. It is to require that the experience goes with you, because there is no legitimate reason for that experience not to come with you as you separate and combine entities. The purchasing of companies just to acquire their unemployment rate is not a—I don't believe it to be a rare occurrence. That is just, in my opinion, out-and-out fraud. Again, we may not have made it illegal yet, but it is clearly not the intent of the legislation that was passed for that to occur.

We need to clearly establish that there are principles that we are following, and one of those principles is the mandatory transfer of

experience. I think that that is a code that can be passed by this Committee. I think that that is an expectation that all the States have. I think we could even go beyond that and do something that would be very common in business—perhaps not so common here.

Why aren't there performance metrics that we are requiring? Why don't we require the States to have—to achieve an increasingly difficult set, to raise the bar—as we talked about in the corporate setting where we expect to see more actions, more investigations, and a more complete explication of the mandatory transfer of experience regulation. I understand that enforcement is local. The question is, are we going to make it easier for the States to make that enforcement effective, by giving them the tools they need, by providing the training—but, most importantly, by making very clear and very explicit what is illegal?

I really dislike receiving letters saying that SUTA dumping is not illegal. It is against the intent of the law. We simply haven't made explicit how the intent of the law is to play out in the transfer of work experience as companies go about combining and dividing. That single change alone, and requiring States to amend their laws to come to conform with that principle, would have a massively positive impact. Public statements by you all, who are much better at speaking at this, and command a much better podium than we would, perhaps, individually, would let the business community know there is no room—and would let those, the promoters, know there is no tolerance for going around the spirit of the legislation with something that may be legal, but violates the spirit of the law.

Chairman HERGER. Thank you, Mr. Camden. Again, what can be pointed out is, not only are they saving these dollars and becoming more competitive in an ethically, I believe, dishonest way. Those who are being ethical, who are abiding by the law, are paying the difference in higher unemployment rates than they would be paying had this not been taking place. So, one is gaining at the expense of all the others like yourself who are obeying the law. The gentleman from Michigan, Mr. Levin, to inquire.

Mr. LEVIN. Thank you. Well, I think to my colleagues, the witnesses have laid out the problem very clearly—and, I think, the answer. I had the privilege of representing for 10 years—until 6 months ago—the city in which Kelly Services, Inc. is headquartered, and had a chance to come and know the company well. I think we have to do more than admire the company, which I do very much. The gentleman from Kelly Services, Inc. told me about what the response was from a person who headed up the company for so many years, when he asked, knowing the answer, whether they should engage in this. The answer was, no way. The State of North Carolina has made it clear how this can be done, and I think that the GAO has described how, if we don't act, there will be people promoting activity that should not occur.

So, I wanted to just say a few words about the issue that Mr. Houghton has raised—and that is the Federal interest. It seems to me that there is clearly a Federal-State partnership when it comes to employment compensation. This is a combined system, and the Federal Government has laid out certain parameters within which States must act. The question is whether this will be added to the

parameters. It isn't as if the States simply send the money here, we ship it back, and there is no role for us. I think this is an especially urgent issue when we have this high level of unemployment, when States need more resources, not less, to address the needs of the unemployed—including addressing the issues of eligibility. Whatever the figure is, the percentage of people who receive unemployment compensation is less than 50 percent of the people who become unemployed.

It is also, I think, a Federal issue. We don't want States competing for which ones can do worse for their unemployed personnel or Members. We don't want competition based on that, and we don't think it is right that employers compete against other employers as to who can game the system. That is exactly what is happening here. People are gaming the system. There is such a clear Federal role—and there is an urgency here. If we don't act this year with unemployment the way it is, with the recession continuing in one form or another, or with economic difficulties, whatever you want to call it, there is going to be more and more of this, in all likelihood. North Carolina has shown us a model as to how it can be done. It seems to me that we have that experience—we have got the experience of States that know how to do it.

The Department of Labor and the administration ought to send us some legislation, and do it quickly. Then we need to get down and work on it, pass it, and do so in the next few months. If we don't do that, then it won't have any impact for the next year when the experience ratings come out, and we are going to be talking about another year and a half of companies gaming the system to the harm of their competitors—to the harm of employees who are laid off. There aren't the funds there for States to work with, and it is to the harm of the Federal Government, which is now loaning out monies to the States. It affects all of these resources. So, I think Mr. Houghton's question is a very appropriate one, and I think that these four witnesses have given us such a clear answer, that now it is up to us and the administration. Thank you so much for the four of you appearing. You have thrown down the gauntlet, and we need to pick it up.

Chairman HERGER. Thank you, Mr. Levin. The gentleman from North Dakota, Mr. Pomeroy, to inquire.

Mr. POMEROY. Thank you, Mr. Chairman. I will be brief. I am very interested in the information you have brought us, and ascribe myself fully to the comments of the gentleman from Michigan. If consultants are marketing essentially illegal practices, we need to put a stop to it. In addition, we need to, I think, fully air who is doing this and what is out there by way of competitive pressures. I was very surprised to learn the major accounting firms are in a frantic competition with one another relative to tax shelters. I had a friend who was a partner in one. He hated it. He wanted to be a consultant and an accountant, not a salesman on shady accounting schemes. That was what he was reduced to, and competition drove right across the biggest accounting firms in this country. Who are the consulting firms that are selling these products? One of the GAO representatives here, if you could go ahead and name them, I think that is important information.

Mr. DESAULNIERS. Congressman, GAO has a policy that we do not, in a public forum, disclose names. I would be happy to disclose those names to you privately, or with your staff after the hearing, but it is our policy not to publicly name names.

Mr. POMEROY. Well, let me just see, then, if there is any other way I can get it out of you. Would I recognize the name?

Mr. DESAULNIERS. I do not think so.

Mr. POMEROY. That tells me it is not one of the major accounting firms that——

Mr. DESAULNIERS. No, it is not.

Mr. POMEROY. I am relieved to hear that. We don't have any information that they are doing this, do we?

Mr. DESAULNIERS. Well, I think that Mr. Camden provided that information.

Mr. CAMDEN. The answer is that they all have over the past few years. I disagree somewhat with the characterization that it is illegal, because if it was clearly illegal, it would have been easier to stop it. We have been careful to use the word unethical, and not the phrase, "true to the spirit of the law." They have proposed unethical schemes, maybe pushing right up to the edge of the gray zone. I know these firms. I know many of the partners, and I don't believe that they crossed into an area that they would view as blatantly illegal. I happen to think that is the wrong standard, but I would object to the characterization as selling an illegal practice.

Mr. POMEROY. Right. I am reading here from an article that appeared on Charlotte.Com—in the Charlotte Observer. "It is clear at least two major accounting firms, Deloitte & Touche and Peat Marwick International/Klynveld Main Goerdeler (KPMG), were pushing the maneuver in North Carolina as recently as last fall, according to publicly available documents and Observer interviews with officials from three companies who said they were pitched the technique."

So, Mr. Camden, maybe you can tell me how this works. So, you have got—assuming the information in this is correct—people from Deloitte & Touche or KPMG coming up and saying, we think you ought to hire us as a consultant, let us show you what we can save you in your unemployment compensation benefits—we think that you can basically shift some of the risk here. Basically, they then would go on to elaborate a SUTA dumping procedure, and then hope that the employer would hire them so they could do the template on SUTA dumping for purposes of artificially reducing their risk for purposes of UI premium?

[The information follows:]

Accounting firms' role in tax ruse scrutinized

Results in lower N.C. jobless taxes

TONY MECIA

Staff Writer

As Congress holds hearings today on an accounting maneuver some companies use to skirt unemployment taxes, N.C. investigators are examining the role major accounting firms played in the controversial practice.

The accounting move occurs when a company creates subsidiaries that pay less money than they ordinarily would into a state fund for jobless workers. Officials with the N.C. Employment Security Commission worry that the practice is sucking

millions of dollars from the fund—and sticking companies that don't use the technique with higher tax bills.

The General Assembly passed a law last month clearly criminalizing the practice. Today, North Carolina's enforcement efforts will be presented in a Subcommittee hearing of the House Ways and Means Committee in Washington, which is concerned about abuses under the practice.

Since launching their investigation late last year, N.C. officials have focused on the companies employing the practice, which the state says are principally manufacturers and construction firms.

But now, state officials say they have developed a better understanding of the companies pushing the technique, which officials call state unemployment tax dumping, or "SUTA dumping."

"It appears that major accounting firms believe they can make money by selling SUTA dumping plans to North Carolina businesses," said Fred Gamin, a senior staff attorney with the ESC who is heading the investigation. "It's illegal."

Gamin would not name the accounting firms under scrutiny, although he said the ESC is looking at companies that advocated the technique as well as those that performed outside audits of firms that used it. It's unclear what action the ESC may take.

But it is clear that at least two major accounting firms—Deloitte & Touche and KPMG—were pushing the maneuver in North Carolina as recently as last fall, according to publicly available documents and Observer interviews with officials from three companies who said they were pitched the technique.

They were pushing the technique in 2001 and 2002, just as a series of financial scandals subjected the accounting industry to renewed scrutiny. At the same time, the economy was sluggish, and employers were beginning to pay higher unemployment taxes to pay for increased numbers of jobless claims.

Deloitte, which told The Observer in January it believes the technique to be legal and was advising companies on how to use it, declined to comment for this article.

KPMG spokesman Tim Connolly said Wednesday, "Our advice was consistent with the law, but we don't discuss the work we perform for clients."

In a report to be released at the congressional hearing today, the General Accounting Office said tax consultants are continuing to advise companies on the maneuver. A GAO investigator, posing as the owner of an East Coast construction company, asked four consulting firms about avoiding unemployment insurance taxes. Three of the firms offered to help; the fourth demurred, explaining that the practice is illegal in many states. The GAO didn't name the firms.

According to representatives of the three companies interviewed by The Observer, the pitch generally went like this:

The accounting firms would call the financial offices of targeted companies, briefly explain the technique and seek to set up a meeting. The cost of implementing the practice ranged from $50,000 to $150,000.

But the savings, they said, could be far greater. Other companies are doing it, they said.

One of the companies interviewed by The Observer, an N.C. manufacturer, said KPMG's Charlotte office promised significant savings by using the accounting method. In a letter to the company last fall, which The Observer was allowed to read, KPMG said it had saved an N.C. textile company $6 million in unemployment taxes over three years.

The company's chief financial officer told The Observer this week that he found the offer tempting but declined because it didn't seem ethical, even if it was legal.

"Our feeling from the beginning has been, this is borderline fraud," said the CFO, who said he also received a similar pitch from Deloitte.

Fearing business fallout from being quoted publicly, he asked not to be identified.

Another company, R.L. Stowe Mills Inc. in Belmont, said it found no compelling business reason to use the technique when a major accounting firm pitched it last fall, even if it would have resulted in "very significant" savings.

"We did not give it a lot of consideration because it didn't feel right to us," said CFO Barry Pomeroy, who would not name the accounting firm. "It seemed to us to be more of an evasion technique rather than an avoidance technique. We'll avoid taxes legally all day long, but when you get into evasion. . . ."

A manager with the third company told The Observer its executives relied on assurances from Deloitte when they bought into the maneuver. In a meeting in the second half of 2001, the manager asked a Deloitte tax adviser if the move was legal.

"There was not always a direct answer back to me, other than the fact that there was a loophole there," said the person, who asked not to be identified for fear of retribution.

The plan, the manager said, was to create new subsidiaries every year, regularly transferring workers into them. That would enable those units to pay low tax rates because they have no history of layoffs—or of tapping the state fund established to pay benefits to laid off workers.

The Charlotte-area company used the practice, saving several hundred thousand dollars in 2002. But "things got hot" in January 2003 when The Observer published an article saying state officials were examining the practice, the manager said. The workers were then transferred from the subsidiary back to the original company.

At the time, state law did not specifically address the technique, and several tax advisers told The Observer they considered it to be legitimate tax planning. Later, state officials said they considered the practice illegal. They made sure it was in the N.C. law passed in May.

The state is continuing to investigate about a dozen companies that have used the practice. ESC officials have declined to name them. They have collected $18,000 in back taxes from one Virginia-based manufacturer with N.C. operations, and say they nixed the company's attempt to skirt about $400,000 a year.

Nationally, several states including North Carolina identified a total of $120 million in losses from SUTA dumping in the past 3 years, the GAO reports.

As recently as this March, Deloitte was still encouraging use of the practice in other states.

In a March 25 tax seminar archived on the firm's Web site, a principal with Deloitte's Boston office said state unemployment tax planning was "still valid planning" because other states "have not made a movement to change this law yet."

But in light of heightened attention by N.C. newspapers and by the U.S. Department of Labor, he recommended transferring into the subsidiaries not just employees, but also assets. Give the subsidiaries more heft, he advised, by creating a "business-purpose document" and doing financial statements for them.

"The more substance that we have in these transactions," he said, "the more we can hold our head high."

Mr. CAMDEN. Yes, sir.

Mr. POMEROY. I think that stinks, and I think that an important part of the responsibility that Chairman Houghton and I have in the Subcommittee on Oversight, is to bring this information out in public forum. I would like to think that, if business ethics don't mean anything anymore to some of the firms that we have long held in the highest light—in terms of their adherence to business ethics and business standards—then hopefully the prospect of corporate embarrassment ought to mean something to them. It is an old adage among Members of Congress: don't do anything you wouldn't want to read about in the paper.

Well, I would like to see these guys think at least twice about—don't do anything you don't want tossed around a Committee on Ways and Means hearing room in public forum. I really do think that that is beneath the proud reputation of Deloitte & Touche and KPMG, and beneath the fine people that work in those firms. I appreciate very much what you have brought to us in this regard, and look forward to bringing information out.

Chairman HERGER. I thank the gentleman from North Dakota. Chairman Houghton, to inquire.

Chairman HOUGHTON. I want to bring this thing back into an overall perspective. Since the beginning of time, people have tried to game the system, and they will continue to game the system. We have seen it, whether it is public accounting white-washing, or whether it is earnings stripping, or a special partnership and off balance sheet borrowing—or whatever it is. As far as SUTA dumping is concerned, clearly it is wrong—it is not in the spirit of what we are all about, what this country stands for, what the laws, and

its intentions, are. The question is, what do you do about it—and the thing I think we have got to be careful of, is that we don't use a sledgehammer on something where it will have real shock waves in other areas. I was in business for many, many years, and good laws were put in under extraordinary circumstances. Yet they had a paralyzing effect on a variety of different actions which we wanted to take. So, as we make these decisions up here, we want to be conscious of that, and we want to make sure that we attack the problem and just don't ruin the system. I just wanted to say that, Mr. Chairman, and I thank you very much for being here.

Chairman HERGER. Thank you, Chairman Houghton. Certainly I have to echo the comments of Chairman Houghton. We certainly don't want to do anything that is going to disrupt what our natural business practice is, but I believe what we have been hearing about in this hearing are not natural business practices. These are practices that, as I hear the testimony, are made to game the system—and this is at the expense of other employers and other businesses who are placed in a very unfair competitive position because of this. So, it is something that this Committee intends to work with you to help correct. With that, my last question would be to any of you who would like to comment. How difficult is it for States to identify companies that engage in this SUTA dumping practice? Any of you wish to answer?

Mr. CLEGG. To begin with, we knew that it was out there, but we did not truly uncover it until we looked at our voluntary contributions. States have got to, number one, acknowledge the fact that SUTA dumping exists. It is an emerging issue. Some States are so deep in trying to dig out of their current unemployment issues, they are not having the resources to deal with the tax end of the house. Through that acknowledgment—through an acknowledgment that this is occurring in a multi-state situation—we are acknowledging that we don't want people to SUTA shop. Education has a lot to do with it, but our real time computerized program is allowing us to make that determination by looking at factors which we have seen across the board that SUTA dumpers have in common with one another.

Every entity that pulls up in our system is certainly not a SUTA dumper, but it is clearly a way to look at very clear evidentiary factors that we have seen across time that might bear further investigation. The 10 individual corporations we will be going to see in the next 30 days were determined from that very program, and we certainly hope to be able to, in forums like this, discuss that program. We hope to be able to help other States determine that, as State employment security agencies, we are all in the same boat, and what hurts one hurts us all, particularly with the multi-state and transient nature of commerce in today's world. We are not living in a vacuum, and it is very important that we all understand the severity of this problem, and all do something about it.

Chairman HERGER. Thank you very much. Again, I appreciate your testimony—for your coming here today. It has been a very interesting and informative hearing. It has also been a pleasure to work with our colleagues on the Subcommittee on Oversight. With that, this hearing stands adjourned.

[Whereupon, at 3:30 p.m., the hearing was adjourned.]

[Submission for the record follows:]

Statement of the National Association of Professional Employer Organizations, Alexandria, Virginia

The National Association of Professional Employer Organizations (NAPEO) appreciates the opportunity to submit this statement for the record of the Subcommittees' June 19, 2003 hearing to examine fraud and abuse in the Unemployment Compensation program. We commend Chairman Herger and Chairman Houghton and the members of the Subcommittees for providing the oversight necessary to protect the integrity of this important State-Federal partnership and to protect workers and employers who play by the rules. Like other employers, professional employer organizations ("PEOs") benefit from a strong and equitable Unemployment Compensation program, and NAPEO supports broad-based efforts to eliminate any practice that undermines the integrity of the system.

As you are aware, the Unemployment Compensation program is supported by unemployment taxes paid by employers. Today, state programs rely on the basic concept of "experience rating" to establish a particular employer's rate of taxation. Under an experience rated system, an employer with a higher incidence of successful claims for unemployment benefits pays a higher rate of unemployment tax than an employer with fewer successful claims. Unfortunately, evidence suggests that some employers are engaging in aggressive business practices designed to artificially improve their experience rate, thereby avoiding their unemployment tax liability. This "SUTA dumping" can undermine the stability and integrity of the experience rated Unemployment Compensation program. NAPEO has supported, and will continue to support all efforts to curb SUTA dumping that (1) apply equally across the board to all employers engaged such practices, (2) are carefully crafted to recognize legitimate corporate restructurings, and (3) do not penalize employers who choose to utilize the services of a PEO.

NAPEO has nearly 500 members found in all 50 states, and represents more than 70% of the industry. PEOs assist mainly small and mid-sized businesses, covering almost every American industry, in fulfilling their responsibilities as employers by assuming many human resource and employment functions of the PEO customers. The PEO generally assumes responsibility for paying wages and employment taxes for all the workers of its client companies. It maintains employee records, handles employee complaints, and provides employment information to workers. Significantly, the PEO provides workers a variety of benefits, including retirement (usually a 401(k) plan), health, dental, life insurance, and dependent care. For many of these workers, the provision of such benefits by the PEO represents their first opportunity to obtain these benefits.

Of particular relevance to this hearing, PEOs enhance and create efficiencies in the unemployment compensation system by serving as the entity responsible for unemployment insurance of all worksite employees. Not only does the PEO maintain extensive records regarding worksite employees, it has highly specialized personnel dedicated to complying with various state unemployment compensation programs. This relieves the small business owner of certain recordkeeping and compliance burdens, allowing the business to focus on its core function rather than monitoring filing deadlines and other compliance oriented matters. This arrangement not only reduces the governmental burden of collecting unemployment obligations from a myriad of small businesses, it also assures consistent compliance with complex unemployment tax laws and the timely payment of unemployment taxes—clearly an improvement for both PEO customers and state unemployment compensation systems. Additionally, since the PEO is collecting and remitting unemployment taxes for a larger pool of workers, the PEO is required to remit taxes on a more frequent basis than the small or mid-sized business client, which serves to boost compliance and to get the unemployment taxes into state coffers on a more timely basis.

Importantly, by providing small and mid-sized employers with human resource management services, the PEO relationship reduces unemployment compensation claims. It has long been recognized that quality, proactive human resource tools, such as accurate job descriptions, performance appraisals, and improved employer/employee communications can improve employment retention, resulting in fewer unemployment claims. In addition, some PEOs have reassigned worksite employees from one client to another to minimize unemployment claims, when reassignment does not interfere with the business interests of the client. Once again, these proactive practices not only reduce claims, but, more importantly, result in working Americans retaining gainful employment.

PEOs assist the unemployment system by contesting and documenting wrongful claims for unemployment benefits. By delivering these services, a PEO helps sta-

bilize unemployment tax rates, thereby protecting the PEO's viability in a competitive marketplace and eliminating some of the incentive to engage in SUTA dumping.

We applaud the efforts of the Subcommittees to draw attention to the problems caused by SUTA dumping. We encourage the Department of Labor and the States to continue to coordinate broad-based efforts to deal with abusive situations.

In closing, we would also bring to the attention of the subcommittees PEO legislation introduced by Representatives Rob Portman and Ben Cardin—H.R. 2178, the Professional Employer Organization Workers Benefits Act of 2003. Although that bill does not directly affect SUTA, it would provide small and mid-sized business and PEOs with much needed guidance on the intricate web of rules that govern the payment of payroll taxes and would create a certification process for PEOs dealing with Federal unemployment taxes. Companion legislation, S. 1269, has been introduced in the Senate by Senator Grassley.

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