

# CRS Report for Congress

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## State Unemployment Taxes and SUTA Dumping

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### Summary

This report provides a summary of the State Unemployment Tax Acts (SUTA) Dumping Prevention Act of 2004, P.L. 108-295. The term “SUTA dumping” refers to a variety of tax planning strategies used by employers to minimize the tax burden of federally mandated state unemployment taxes. The strategies exploit the differences in methods state employ to determine unemployment tax rates among established employers and the method by which states determine the tax rate of new firms and firms that have either created new subsidiaries or have absorbed other firms. SUTA dumping creates tax inequities when firms avoid their appropriate state unemployment taxes. Firms that follow state unemployment tax law are burdened with additional taxes as a result of the tax avoidance by the firms that engage in SUTA dumping. This report will be updated as legislative activities warrant.

### Overview

**The Unemployment Compensation (UC) Program.** UC is a joint federal-state program and is financed by federal taxes under the Federal Unemployment Tax Act (FUTA) and by state payroll taxes under the State Unemployment Tax Acts (SUTA). The underlying framework of the UC system is contained in the Social Security Act (SSA). Title III authorizes grants to states for the administration of state Unemployment Compensation (UC) laws; Title IX authorizes the various components of the federal Unemployment Trust Fund (UTF); and, Title XII authorizes advances or loans to insolvent state UC programs.

**UC Financing.** Among its 59 accounts, the federal UTF in the U.S. Treasury includes the Employment Security Administration Account (ESAA), the Extended

Unemployment Compensation Account (EUCA), and the Federal Unemployment Account<sup>1</sup> (FUA), 53 state accounts,<sup>2</sup> the Federal Employees Compensation Account (FECA), and two accounts related to the Railroad Retirement Board. Federal unemployment taxes are placed in the ESAA, the EUCA, and the FUA; each state's unemployment taxes are placed in the appropriate state's account. Federal taxes pay for UC administration grants to the states and half of extended UC benefits. State taxes pay for regular UC benefits and half of extended UC benefits.

## What is SUTA Dumping?

The term "SUTA dumping" refers to a variety of tax planning strategies used by employers to minimize state unemployment taxes. The strategies exploit the variation in the effective unemployment tax rates among employers and the methods states determine the tax rate of firms that have either created new subsidiaries or have absorbed other firms. Unemployment taxes are levied on employers based on a combination of established rates and the employer's past history with the UC system. Generally, employers that have had a greater number of unemployed workers in the past have a lower rating and would pay higher UC taxes.

Recently, Congress passed the SUTA Dumping Prevention Act of 2004 (P.L. 108-295), which is intended to end or at least significantly curtail SUTA dumping. SUTA dumping occurs when employers that pay relatively high UC taxes, "dump" workers into an affiliated employer with lower UC taxes. The legality of SUTA dumping schemes varies depending on state laws. According to a Government Accountability Office (GAO) survey, over half of the state administrators felt that SUTA dumping resulted in lost state unemployment tax revenue. Administrators most often cited the employee leasing industry, hospitality industry, and construction industry as engaging in SUTA dumping practices.<sup>3</sup>

**Federal Unemployment Taxes.** A federal tax of 6.2% on the first \$7,000 of a worker's wages (\$434 per worker) is levied on employers. The employer, however, receives a federal tax credit of up to 5.4% (\$378) of the worker's wages for state unemployment taxes. Employers may have a state unemployment tax rate that is less than 5.4% that may be credited toward the federal tax as long as the state's UC tax system complies with federal law. The federal government receives up to \$56 per covered worker from employers.

**State Unemployment Taxes.** State tax rates and base wages are determined by wildly variable state law. In 2004, the wage base ranged from \$7,000 (11 states) to \$27,100 (Alaska). Three states, Alaska, New Jersey, and Pennsylvania, also tax employees to finance the UC fund. Most states augment the base funding formula through expanding the taxable wage base, increasing tax rates, and/or levying special fund fees. In addition, all states use an experience rating to adjust an employer contribution to better reflect the employer's potential reliance on the fund. New firms, those with no past unemployment experience, may be levied a lower tax rate (less than the 5.4% but not less than 1%) than employers with more experience.

<sup>1</sup> The FUA is an account from which advances are made to depleted state trust fund accounts to ensure that UC benefit obligations are met.

<sup>2</sup> The District of Columbia, Puerto Rico, and the Virgin Islands are considered to be states.

<sup>3</sup> U.S. Congress, House Committee on Ways and Means, Subcommittee on Oversight and (continued...)

The state unemployment tax rate of an employer is, in most states, based on the amount of UC paid to former employees. Generally, in most states, the more UC benefits paid to its former employees, the higher the tax rate of the employer, up to a maximum established by state law.<sup>4</sup> The experience rating is intended to ensure an equitable distribution of UC program taxes among employers and encourage a stable workforce. The variation of experience rates creates the opportunities for strategic tax minimization behavior, such as “SUTA dumping.”

Currently, four experience rating systems are used by states to establish an employer’s experience rating: reserve ratio, benefit ratio, benefit-wage ratio, and payroll variation. Each system is intended to fairly distribute the burden based on an employers unemployment history. The focus here will be on the reserve ratio (RR) and benefit ratio (BR) systems because 30 and 17 states, respectively, use these systems.<sup>5</sup> How these tax rates are determined when employers merge or new employers acquire predecessor firms are the basis of most SUTA dumping cases.

**Reserve Ratio (30 states, DC, PR, and VI).** The most common formula is the reserve ratio. Each employer’s rate is calculated as the contributions less UC benefits paid divided by payroll. Stated differently, it is the employer’s historical “net” UC balance divided by total payroll. Most states require employer’s to use all past years when calculating the experience rating. Using all past years tends to minimize the volatility in the ratio resulting from business cycle fluctuations.

**Benefit Ratio (17 states).** The second most common formula is the benefit ratio. The employer’s tax rate under the BR system is calculated as the UC benefits paid divided by total payroll. In contrast to the RR system, the BR system uses the most recent experience, typically the previous three years, to establish the tax rate. The emphasis on more recent experience makes the BR system more sensitive to the business cycle. The pro-cyclical nature of the BR system — UC taxes increase when UC benefits paid increase — may impede economic recovery.

**Employer Experience Rating Transfers.** According to the U.S. Department of Labor (DOL), the transfer of case records, necessitated by firm acquisition and mergers, is automatic in most states.<sup>6</sup> Acquiring firms simply incorporate the predecessor’s case

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<sup>3</sup> (...continued)

Subcommittee on Human Resources, Testimony of Robert J. Cramer, Managing Director Office of Special Investigations, Government Accountability Office, June 19, 2003, (GAO-03-819T). (Hereafter cited as GAO, 2003, at [<http://www.gao.gov/new.items/d03819t.pdf>].)

<sup>4</sup> FUTA, in Section 3303(a), allows credit for a lowered rate of contribution if the rates are based on at least three years of UC program experience. Federal law allows states to make new firms eligible for reduced rates after one year. Federal law also allows states to offer new employers a reduced rate immediately; however, the rate must be at least 1%.

<sup>5</sup> The District of Columbia, Puerto Rico, and the Virgin Islands, all use the reserve-ratio system. Delaware and Oklahoma use the benefit-wage-ratio and Alaska uses the payroll variation system. Please refer to U.S. Department of Labor, *Comparison of State Unemployment Insurance Laws 2005*, chapter 2, page 9, for a description of the other two systems.

<sup>6</sup> U.S. Department of Labor, *Comparison of State Unemployment Insurance Laws 2003*, Chapter (continued...)

records when determining the appropriate experience tax rate. Variation among the states occurs in the treatment of transferred employees and how new employers are taxed; this generates opportunities for strategic tax planning like SUTA dumping.

## Methods of SUTA Dumping

There are three basic methods for engaging in SUTA dumping: vertical, horizontal, and acquired rate. A brief description of each method follows below.

**Create a New Business (Vertical Method).** An employer with a high level of UC use can minimize the impact of a poor UC experience rating (and accompanying higher UC taxes) by setting up a new company and gradually transferring some, or all, of its workforce (and accompanying payroll) to the new company with its lower ‘new firm’ UC tax rate. The DOL, Office of the Inspector General found this to be a typical method for the employee leasing firms. In one state, it found it to cause “major” losses to the state’s UTF.<sup>7</sup>

**Transfer Payroll to a Subsidiary (Horizontal Method).** Firms move employees from one unit that has experienced sizable layoffs to a different unit with a relatively lower rate of layoffs, reducing the unemployment-tax bill. Over time, as employees continue to be transferred, the first unit would be eliminated, along with the high turnover rate that boosted unemployment taxes.

**Purchasing an Existing Business (Acquired Rate Method).** Under this scheme, a new business purchases an existing small business with a low UC tax rate. However, the acquisition is not for legitimate business reasons but rather is a shell transaction designed to lower the firm’s UC tax rate. This strategy exploits the existing business’s tax rate that is lower than the state’s new business tax rate. The newly formed entity receives the predecessor’s lower rate. The new business often does not engage in substantially the same business activity as the predecessor business.

## What is Currently in Place to Detect and Minimize SUTA Dumping?

Presently, states detect potential SUTA dumping schemes by manually reviewing employer tax records. The DOL developed an automated SUTA Dumping Detection System in a pilot program where seven states<sup>8</sup> were selected for testing. According to DOL,<sup>9</sup> the testing is complete and the detection system ready to be distributed to the states. The automated detection system extracts information from tax files, produces a

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<sup>6</sup> (...continued)  
2, pp. 24-27.

<sup>7</sup> U.S. Department of Labor, Office of Inspector General, *Unemployment Insurance Integrity: Fraud and Vulnerabilities in the System*, No. 1P-03-315-0001-PE, Mar. 31, 1999, p. 7, at [[http://www.itsc.org/PDF/OIG\\_UI\\_Paper.pdf](http://www.itsc.org/PDF/OIG_UI_Paper.pdf)].

<sup>8</sup> Nebraska, North Carolina, Rhode Island, Texas, Utah, Virginia, and Washington.

<sup>9</sup> Telephone conversation with the U.S. Department of Labor, Employment and Training Administration, on May 17, 2005.

prioritized list of employers, estimates the potential loss of UC revenue, and creates a report for further investigation. States received information on how to submit a supplementary budget request for implementing the detection system and the requests are due in June 2005.

States have a variety of measures in place to minimize SUTA dumping. According to the GAO, in 2003, 21 state UC administrators reported that their programs have no laws specifically addressing SUTA dumping. Twenty-nine state administrators indicated that they have laws addressing SUTA dumping, but seven 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.<sup>10</sup>

The manner in which states treat new, successor, and predecessor firms may deter SUTA dumping. In the GAO survey, UC 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.<sup>11</sup> Listed below are the administrative considerations that states (indirectly) use to address the forms of SUTA Dumping.

**New Firms.** Federal requirements do not allow an experience rating to be granted unless the state has at least a one-year record of the employer's experience. Without such a record there would be no basis for rate determination. However, states are allowed to give new firms a "new firm" experience rating that may be lower than the expected tax for the firm (perhaps because it is in an industry that has a high use of the UC system).

**Successor Firms.** Most states have statutes or regulations that determine the rate to be assigned the successor employer from the date of the transfer to the end of the rate year in which the transfer occurs. The rate assignments vary with the length of time since the acquisition of the firm. Over half of the states require that an employer who has a rate based on actual UC experience must continue to pay that rate for the remainder of the rate year. If the predecessor firm had a much higher unemployment tax rate, this may encourage SUTA Dumping. Other states assign a new rate based on a combination of the employer's experience and the acquired firm's experience.

**Predecessor Firms (Addresses Acquired-Rate Method).** All state laws specify the conditions under which the experience rating of a predecessor employer may be transferred to an acquiring employer. In some states, the authorization for transfer of the rating is limited to total transfers (i.e., the record may be transferred only if a single successor employer acquires the predecessor's organization and substantially all of its assets). Other states authorize partial as well as total transfers where the proportion of the predecessor's record that pertains to the acquired portion of the business may be transferred to the successor. Some states condition the transfer of the experience rating on what happens to the business after it is acquired by the successor. For example, in

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<sup>10</sup> GAO, 2003.

<sup>11</sup> Ibid.

some states, there can be no transfer if the enterprise acquired is not continued; in three of these states,<sup>12</sup> the successor must employ substantially the same workers.

## New Requirements to Limit SUTA Dumping

**The SUTA Dumping Prevention Act (P.L. 108-295).** The SUTA Dumping Prevention Act requires that states develop standards for employee transfers and impose penalties on firms and advisory groups that promote SUTA dumping techniques as a tax avoidance tool and to impose meaningful penalties on those firms and people who either advise or implement SUTA dumping schemes. P.L. 108-295 permits states to use certain information in the National Directory of New Hires from the Social Security Administration in the administration of federal and state UC laws.<sup>13</sup> P.L. 108-295 also requires the U.S. Secretary of DOL to submit to the Congress, not later than July 15, 2007, a report that (1) assesses the statute and appropriateness of state actions to meet its new requirements; and (2) recommends any further congressional action that the Secretary considers necessary to improve the effectiveness of the amendments.<sup>14</sup> In the Unemployment Insurance Program Letter No.30-04, DOL provided draft legislative language for the states that DOL felt would comply with the intent of P.L. 108-295.<sup>15</sup>

The changes in the state laws are expected to be complete by the end of FY2006. States generally have followed DOL guidelines, although there is variation. According to DOL<sup>16</sup> the following states have enacted legislation: Arizona, Arkansas, California, Georgia, Idaho, Indiana, Kansas, Kentucky, Michigan, Mississippi, Montana, New Mexico, North Dakota, South Carolina, South Dakota, Utah, Virginia, Washington, and Wyoming. As of May 16, 2005, seven additional state legislatures (Colorado, Florida, Hawaii, Maryland, Nevada, Oklahoma, and Oregon) have passed SUTA dumping legislation but the legislation has not been signed by the respective governors.

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<sup>12</sup> California, District of Columbia, and Wisconsin.

<sup>13</sup> The Office of the Inspector General of DOL found the New Hire detection system is more effective and efficient than the earlier crossmatch system in identifying UC overpayments that occur when UC claimants fail to report earnings while simultaneously working and claiming benefits. Most, but not all states, now use the New Hire detection system. The report also recommended that DOL encourage state UC programs to access the NDNH and coordinate efforts with the Department of Health and Human Services and the state UC programs to accomplish full integration. U.S. Department of Labor, Office of Inspector General, Office of Audit, *Unemployment Insurance Benefit Payment Control New Hire Detection Is A Better Method For Establishing UI Overpayments Than The Wage/UI Benefit Crossmatch*, No. 05-04-002-03-315, Sept. 30, 2004.

See [<http://www.oig.dol.gov/public/reports/oa/2004/05-04-002-03-315.pdf>].

<sup>14</sup> See Section 2(b) of P.L. 108-295.

<sup>15</sup> See [[http://www.ows.doleta.gov/dmstree/uipl/uipl2k4/uipl\\_3004a2.htm](http://www.ows.doleta.gov/dmstree/uipl/uipl2k4/uipl_3004a2.htm)].

<sup>16</sup> Telephone conversation with the U.S. Department of Labor, Employment and Training Administration, on May 17, 2005.

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