Legislative Analysis

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REVISE SUTA DUMPING PROHIBITIONS

House Bill 6386 (H-1) as passed by the House
Sponsor: Rep. Bob Constan
Committee: Labor

First Analysis (10-28-08)

BRIEF SUMMARY: The bill would amend the Michigan Employment Security Act's to bring provisions prohibiting SUTA dumping into conformity with federal statutory requirements and U.S. Department of Labor guidance.

FISCAL IMPACT: The bill ensures the continued receipt of federal funding for the administration of the state's unemployment insurance program. The FY 2008-09 appropriation totals approximately $136.5 million, which includes funding for UIA administrative costs, UIA-related bureau and departmental overhead costs, UIA-related information technology costs, and the MES Board of Review. (Additional fiscal information is provided later in the analysis.)

THE APPARENT PROBLEM:

Under the Michigan Employment Security Act, an employer's state unemployment tax rate is based on its "experience rating" where, in general, employers that have more former employees receiving unemployment benefits have a higher tax rate than those employers with fewer former employers receiving benefits.[1] In recent years, employers have used a variety of tax planning strategies to reduce their state unemployment tax burden. Common "SUTA dumping" strategies include creating a new business (a firm with a high tax rate creates a new company, typically subject to a lower rate, and transfers employees to the new firm); transferring employees to a subsidiary with a lower tax rate; or acquiring a business with a lower tax rate in a shell transaction where the new business does not engage in the same business as the old one. (SUTA refers to 'state unemployment tax act.')

Prohibitions against SUTA dumping were added to the federal Social Security Act with the enactment of the SUTA Dumping Prevention Act of 2004, P.L. 108-295, 42 U.S.C. 503(k). In general, the act requires that states, as a condition of receiving federal funding for the administration of state unemployment insurance programs, enact laws prohibiting SUTA dumping and imposing meaningful penalties for knowingly violating (or attempting to violate) state SUTA dumping prohibitions.[2] Following enactment of P.L. 108-295, the legislature and governor enacted Public Act 18 of 2005 (SB 171), amending the Michigan Employment Security Act to prohibit SUTA dumping. The U.S. Department of Labor,

[1] State UI tax rates range from 0.06% to 10.3%, exclusive of any penalties imposed.

[2] Specifically, the act, 42 USC 503(k)(1)(a), requires that state unemployment insurance (UI) laws to provide "that if an employer transfers its business to another employer, and both employers are (at the time of transfer) under substantially common ownership, management, or control, then the unemployment experience attributable to the transferred business shall also be transferred to (and combine with the unemployment experience attributable to) the employer to whom such business is so transferred." See also, Congressional Research Service Report RS22069, *State Unemployment Taxes and SUTA Dumping*, by Steven Maguire and Julie Whittaker.

however, has indicated to the Unemployment Insurance Agency (UIA) that the state's SUTA dumping law needs to be amended to be in conformity with federal law, notwithstanding the "conformity assurance clause" [MCL 421.22b(6)] contained in the Michigan Employment Security Act. Legislation bring state law into conformity has been introduced.

THE CONTENT OF THE BILL:

The bill would amend the Michigan Employment Security Act's provisions on SUTA dumping in the following manner to bring the law into conformity with federal requirements and U.S. Department of Labor guidance:

- The bill deletes a provision, MCL 421.22b(1), that prohibits a person from transferring or acquiring a trade or business for the *sole or primary* purpose of reducing the state unemployment tax rate.

- The bill clarifies that if the UIA determines that a person who is not an employer (at the time of a transfer) acquires all or portion of a trade or business for the sole or primary purpose of obtaining a lower tax rate the UIA *shall not transfer the unemployment experience but* shall assign the employer the applicable new employer tax rate (2.7%). [The language in *italics* would be added by the bill.]

- The act provides that when there is a transfer of a trade or business between employers with substantial commonality, the experience rating attributable to the transferred business or trade shall be transferred to the transferee employer. In this instance, the contribution rates of both employers are recalculated. If, however, a transfer occurs for the sole or primary purpose of reducing the UI tax rate, the experience accounts of the employers involved are combined into a single account, and a single UI tax rate is assigned to the account. The bill would delete the condition that, for the experience accounts to be combined, a transfer would have to be made for the sole or primary purpose of lowering the UI tax rate. *That is to say, experience accounts would be combined and a single rate would be applied whenever there is a transfer between businesses with substantial commonality.*

- Under the act, violations of the SUTA dumping prohibitions are punishable by (1) the highest contribution rate (10.3%) for the rate year in which the violation occurred and the next three rate years; or (2) an additional tax of 2%, if the employer currently pays the highest rate or if increasing the rate to the highest rate results in a rate increase of less than 2%. The bill clarifies that "rate year" means "calendar year" and also specifies that the 2% penalty (when applicable) applies in the violation year and the following three years.

- The act defines "SUTA Dumping" as the transfer of all or a portion of a trade or business solely or primarily for the purpose of reducing the contribution [unemployment tax] rate or reimbursement payments in lieu of contributions under the act. The bill redefines "SUTA Dumping" as transferring all or part of a trade or business in a manner that results in a violation of Section 22b or acquiring all or part of a trade or business solely or primarily for the purpose of reducing the contributions rate or reimbursement payments in lieu of contributions requirement under this act.

- The act requires the UIA to determine whether a *transfer* is made for the sole or primary purpose of obtaining a lower unemployment tax rate. The bill specifies, instead, that the UIA shall determine whether a *business is acquired* for the sole or primary purpose of obtaining a lower unemployment tax rate.

MCL 421.22b

BACKGROUND INFORMATION:

Department of Labor Guidance

Following enactment of the P.L. 108-295, the U.S. Department of Labor provided guidance to state unemployment agencies with Unemployment Insurance Program Letter (UIPL) 30-04 (August 13, 2004)[3] and, subsequent to that, UIPL 30-04, Change 1 (October 13, 2004)[4]. UIPL 30-04 contains a series of Questions and Answers (Attachment I) as well as draft legislative language for use by states (Attachment II). The minimum requirements for state SUTA dumping laws are[5]:

- *Mandatory Transfers.* Unemployment experience must be transferred whenever there is substantially common ownership, management or control[6] of two employers, and one of these employers transfers its trade or business (including its workforce), or a portion, to the other employers. This requirement applies to both total and partial transfers of business.[7]
- *Prohibited Transfers.* Unemployment experience may not be transferred, and a new employer rate (or the state's standard rate) will instead by assigned, when a person

[3] UIPL 30-04 is available on-line at [http://wdr.doleta.gov/directives/attach/UIPL30-04.cfm] and in the Federal Register (69 FR 58550) from September 30, 2004 at [http://edocket.access.gpo.gov/2004/pdf/04-21917.pdf].

[4] UIPL 30-04, Ch. 1 is available on-line at [http://wdr.doleta.gov/directives/attach/UIPL30-04_Ch1.cfm] and in the Federal Register (69 FR 65654) from November 15, 2004 at [http://edocket.access.gpo.gov/2004/pdf/E4-3162.pdf].

[5] UIPL 30-04, Attachment I, Q&A 1.

[6] UIPL 30-04, Attachment I, Q&A 6 provides that in determining whether there is substantial commonality between employers states, "must examine the facts of each case using reasonable factors. Among other things, the state would consider the extent of commonality or similarity of: ownership; any familial relationships; the principals or corporate officers; organizational structure; day-to-day operations; assets and liabilities; and stated business purposes. Nothing prohibits a state from exceeding the minimum Federal requirement by lowering this threshold test to 'any' common ownership, management or control. This will meet the Federal law requirement as it will include all cases where 'substantially common ownership, management or control' exists." UIPL 30-04, Change 1, Attachment I, Q&A 1-3 provides that "'substantially' could include less than 50% common ownership, management, or control. 'Substantial' common management, for example, might even occur where Company A and Company B share only one manager, but that one manager exercises pervasive control as the chief executive officer of both companies."

[7] 42 USC 503(k)(1)(A). UIPL 30-04, draft legislative language (Attachment II) provides, "[i]f an employer transfers its trade or business, or a portion thereof, to another employer and, at the time of the transfer, there is substantially common ownership, management or control of the two employers, then the unemployment experience attributable to the transferred trade or business shall be transferred to the employer to whom such business is so transferred. The rates of both employers shall be recalculated and made effective immediately upon the date of the transfer or business." UIPL 30-04, Attachment 1, Q&A 3 provides an example: Corporation A is assigned the state's maximum rate (10.3% in Michigan). It establishes a shell corporation that is treated as a separate employer for [UI] purposes. The shell eventually qualifies for the state's minimum rate (0.06% in Michigan). Corporation A then transfers all or some of its workforce to that shell. The result, absent the amendments, would be that, even though Corporation A controls the shell and its operations, it escapes the maximum rate on the transferred workforce and instead pays the minimum rate. Under the amendments, if the workforce is transferred to the shell, then the unemployment experience attributable to the transferred workforce must also be transferred to the shell…"

who is not an employer acquires the trade or business of an existing employer. This prohibition applies only if the [UI] agency finds that such person acquired the business solely or primarily for the purpose of obtaining a lower rate of contributions.[8]

- *Penalties for SUTA Dumping.* "Meaningful" civil and criminal penalties must be imposed on persons "knowingly" violating or *attempting to violate* the two requirements discussed above. These penalties must also be applicable to any person (including the person's employer) who knowingly gives advice leading to such a violation.[9]

- *Procedures*. Procedures for identifying SUTA dumping must be established. The exact procedures do not need to be specified in state law, but state law must specifically provide for the establishment of such procedures.[10]

The guidance notes that "[t]o be 'meaningful,' the penalty must have the effect of curtailing SUTA dumping. Minimal penalties will not accomplish this end. Concerning cases where only civil penalties are imposed, a monetary penalty must be of sufficient size that an employer will not be tempted to SUTA dump. A flat fine against SUTA dumping may not be a meaningful deterrent. For example, if a corporation that attempted to dump $2 million in SUTA taxes is fined $5,000, this will likely not be a meaningful deterrent against future attempts to SUTA dump. For that reason, the draft legislative language attached to this UIPL takes the approach that an employer who violated (or attempted to violate) the SUTA dumping prohibitions be assessed the maximum tax rate, or, if assigning the maximum rate does not result in a rate increase of at least 2% of taxable wages, then a penalty rate of 2% of taxable wages will instead be assessed for the rate year in which the violation occurred (or was attempted) and the following three years. States are free to vary this penalty (including assessing both rate increases and fines) but any penalty must have significant financial impact to have a deterrent effect."[11]

[8] 42 USC 503(k)(1)(B). UIPL 30-04, Attachment 1, Q&A 17 provides an example: Person A (not an employer) purchases a flower shop with a tax rate of 0.5%, and starts a manufacturing firm. The flower business, in turn, stops completely or becomes only an incidental part of the business as a whole. Had the person not purchased the flower shop, it would have the higher new employer rate (2.7% in Michigan). It is apparent that the transfer was primarily for the purpose of obtaining a lower tax rate and, therefore, the business is subject to the new employer rate, rather than the lower rate of the transferred business. UIPL 30-04, draft legislative language (Attachment II) provides, "[w]henever a person who is not an employer under this [act] at the time it acquires the trade or business of an employer, the unemployment experience of the acquired business shall not be transferred to such person if the [UI agency] finds that such person acquired the business solely or primarily for the purpose of obtaining a lower rate of contributions. Instead, such person shall be assigned the [applicable] new employer rate under [the act].

[9] 42 USC 503(k)(1)(D)

[10] 42 USC 503(k)(1)(E)

[11] UIPL 30-04, Attachment I, Q&A 21. The draft legislative language (UIPL 30-04, Attachment II) includes the following penalty provision: "[i]f the person is an employer, then such employer shall be assigned the highest rate assignable under this Chapter for the rate year during which such violation or attempted violation occurred and at such highest rate for any year, or if the amount of the increase in the person's rate would be less than 2 percent for such year, then a penalty rate of contributions of 2 percent of taxable wages shall be imposed for such year."

Department of Letter Correspondence with the Unemployment Agency

Since the enactment of federal and state SUTA dumping prohibitions, the U.S. Department of Labor has raised a few concerns with Michigan's Unemployment Insurance Agency regarding the state's implementation of P.L. 108-295. The issue revolves largely around MCL 421.22b(1)(a), which prohibits the transfer or acquisition of a business "for the sole or primary" purpose of reducing the unemployment tax rate. In an October 27, 2006 letter to the UIA, the U.S. Department of Labor stated, "[d]uring a recent site visit to Michigan…the agency indicated that it interprets its law to only mandate the transfer of experience between entities with substantial commonality when the agency can demonstrate that the employer made the transfer of trade or business 'solely or primarily' to obtain a lower rate of contribution. Section 303(k), SSA, provides that state law must provide that experience shall be transferred when there is a transfer of trade or business and the entities have substantial commonality. As a result, once the [UI] agency determines there has been a transfer of trade or business, and that, at the time of transfer, the entities shared substantially common ownership, management or control, the [UI] agency must transfer the experience. Section 303(k), SSA does not permit the state [UI] law to limit this transfer requirement based on a person's intent in transferring [the] trade or business. Since Michigan is limiting the mandatory transfer of experience requirement only to those cases when the agency can demonstrate that the intent behind the transfer of [the] trade or business was for the sole or primary purpose of obtaining a lower rate of contributions, an issue is raised with Federal [UI] law."

In a follow up letter, dated September 10, 2007, the department indicated to the UIA that the Social Security Act does not permit limiting the imposition of penalties for SUTA dumping "to cases where transfers are made 'solely or primarily' for the purposes of [UI] tax evasion. If Michigan law is interpreted to provide for such a limitation, an issue exists. We note that, in re-reviewing Section 421.22b(1)(a), it is not clear to us what purpose it serves. Therefore we recommend deleting it."

The letter of September 10, 2007 also raises an issue with the definition of "SUTA dumping" at MCL 421.22b(5)(d). The letter notes, "for mandatory transfers, it does not matter whether the 'sole or primary' purpose was to obtain the lower rate. Although the term 'SUTA dumping' is not used elsewhere in the statute, a reviewing authority could use this definition to limit the application of the mandatory transfer provisions and relevant penalties. Since it is not clear to us what purpose this definition serves, we recommend it either be deleted or broadened to clearly include all forms of SUTA dumping under the SSA."[12]

Finally, the letter of September 10, 2007 also raises an issue with the provision, MCL 421.22b(3), requiring UIA to determine whether a transfer is made for the sole or primary purpose of obtaining a lower unemployment tax rate. (This provision is amended by the bill; see the last bullet point in the Content Section, above.) To this point, the letter states, "[a]lthough the word 'transfer' is used, the criteria appear to apply only to cases where a person acquires a business for purposes of obtaining a lower rate. In other words, it appears intended only to apply to the prohibited transfer, and not the mandatory transfers. To avoid

[12] The act only uses the phrase "SUTA dumping" in provisions prohibiting the UIA from promulgating rules defining SUTA dumping and in requiring the agency to submit annual reports on its SUTA dumping activities.

confusion on this point, we recommend this section be amended to either change the word 'transfer' to 'acquisition' or to cite [the] prohibited transfer provision of your law."[13]

FISCAL INFORMATION:

As noted above, the bill ensures the continued receipt of federal funding for the administration of the state's unemployment insurance program. The FY 2008-09 appropriation totals approximately $136.5 million, which includes funding for UIA administrative costs, UIA-related bureau and departmental overhead costs, UIA-related information technology costs, and the MES Board of Review.

The Federal Unemployment Tax Act (FUTA) and Title III of the Social Security Act generally require the Department of Labor to certify that state unemployment insurance laws meet certain requirements specified in the respective acts.[14] The FUTA, 42 USC 3304(c), provides that "[o]n October 31 of each taxable year the Secretary of Labor shall certify to the Secretary of the Treasury each state whole law he [or she] has previously approved, except that he [or she] shall not certify any State which, after reasonable notice and opportunity for hearing to the State agency, the Secretary of Labor finds has amended its law so that it no longer contains the provisions [required by the act] or has with respect to the 12-month period ending on such October 31 failed to comply substantially with any such provision…"

The Social Security Act, 42 USC 502(a), states that "[t]he Secretary of Labor shall from time to time certify to the Secretary of Treasury for payment to each State which has an unemployment compensation law approved by the Secretary of Labor under the Federal Unemployment Tax Act, such amounts as the Secretary of Labor determines to be necessary for the proper and efficient administration of such law during the fiscal year for which such payment is to be made….The Secretary of Labor's determination shall be based on (1) the population of the State; (2) an estimate of the number of persons covered by the State law and of the cost of proper and efficient administration of such law; and (3) such other factors as the Secretary of Labor finds relevant…" The act, 42 USC 503(b), further provides, "[w]henever the Secretary of Labor, after reasonable notice and opportunity for hearing to the State agency charged with the administration of the State law, finds that in the administration of the law there is…a failure to comply substantially with any provision [required by the act]; the Secretary of Labor shall notify such State agency that further payments will not be made to the State until the Secretary of Labor is satisfied that there is no longer any…failure to comply. Until he [or she] is so satisfied he [or she] shall make no further certification to the Secretary of Treasury with respect to such state…"[15]

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[13] The related provision in the UIPL 30-04 draft legislative language is included in the provision regarding prohibited transfers, cited in footnote 7, above. That provision states, "[i]n determining whether the business was acquired solely or primarily for the purpose of obtaining a lower rate of contributions, the [UI agency] shall use objective factors which may include the cost of acquiring the business, whether the person continued the business enterprise of the acquired business, how long such business enterprise was continued, or whether a substantial number of new employees were hire for performance of duties unrelated to the business activity conducted prior to acquisition."

[14] Specific requirements in the Federal Unemployment Tax Act are found in 26 USC 3304(a) and in the Social Security Act at 42 USC 503(a). See also Part 601 (Administrative Procedure) of Title 20 of the Code of Federal Regulations, 20 CFR 601.

[15] 20 CFR 601.5 provides that payments to states are withheld when, among other reasons (1) any provision by the 42 USC 503 is no longer included in the state UI law; (2) the state UI law has been changed so as to no longer meet the requirements of 42 USC 503 or 26 USC 3304; (3) the state UI agency fails to comply with provisions of the state UI law.

Additionally, the Internal Revenue Code, 26 USC 3302(a), generally provides that taxpayers (employers) may claim a credit against the FUTA for the amount of contributions paid by the taxpayer under a state UI law certified by the Department of Labor under 42 USC 3304. Generally, the credit reduces the effective FUTA rate from 6.2% to 0.8%.[16]

ARGUMENTS:

For:

The bill is necessary to ensure the continued receipt of federal funding for the administration of the state's unemployment insurance program. As indicated above, the U.S. Department of Labor has taken issue with several provisions in the Michigan Employment Security Act that need to be amended to bring state law in conformity with the SUTA dumping prohibitions included in the federal Social Security Act.

POSITIONS:

The Department of Labor and Economic Growth supports the bill. (9-16-08)

Legislative/Fiscal Analyst: Mark Wolf

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.

[16] Under current law, 26 USC 3301, the FUTA rate is 6.2% through the 2008 calendar year and 6.0% in calendar year 2009 and beyond. The Emergency Economic Stabilization Act of 2008 (H.R. 1424) pushes back the rate reduction by one year.