How To Avoid SUTA Dumping Penalties In Mergers And Acquisitions

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No matter how business-savvy it might seem, a plan that reduces an employer's State Unemployment Tax liability can invite some unfriendly scrutiny.

TAX AND CORPORATE attorneys who engage in mergers, acquisitions, and reorganizations have a new and very serious pitfall to avoid for themselves and their clients. It is called State Unemployment Tax ("SUTA") Dumping, and even though you may not have considered yourself a purveyor of tax minimization strategies, the most innocent of corporate decisions that result in the reduction of the SUTA tax rate in a state can have potentially dire consequences. Tax consulting firms, accounting firms, and some employee leasing companies

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have for years advised their clients on tax strategies to reduce their SUTA tax using practices not considered in violation of existing laws. Beginning in 2006, some of these practices became criminally and civilly punishable if attempted, knowingly or inadvertently, in virtually every state.

This article discusses how tax planning that legitimately took advantage of existing tax laws became the subject of federal legislative prohibition and how these new penalties have moved through Congress and the state legislatures without opposition. We will discuss in detail the federal statute, the state laws passed pursuant to its mandate, and the enforcement of these laws in the various states. Finally, we will offer our views on how to avoid punishment for what only seems prudent business advice to a client and how to avoid facing felony charges as an alleged tax evasion practitioner.

FEDERAL AND STATE UNEMPLOYMENT SECURITY PROGRAM • The employment security program was designed to provide workers, whose jobs have been terminated through no fault of their own, monetary payments for a given period of time or until they find a new job. It was initiated through the Social Security Act of 1935 but administered under a separate program in each state based on federal standards and under the oversight of the Secretary of Labor. The program is funded through joint federal and state taxes upon employers, the rates of which are based for the most part on the tax experience of the employer with the state employment security system (specifically, the employer's past hiring and layoff history). An employer with a high turnover in employees would tend to have a tax rate that is higher than an employer with a low turnover rate. For example, a family-owned florist shop would likely be at the lower end of the experience-rated tax spectrum than a contractor or retailer that hires workers during busy periods and lays them off during slower business seasons. This experience-based tax rate computation is at the heart of the problem with SUTA dumping.

New employers are generally assigned a "new employer tax rate" until they have achieved sufficient employment history to become "experience rated." The new employer rate is typically a rather low rate, ranging from 2.5 percent of a company's payroll to 4.1 percent (e.g., 2.7 percent in Georgia, 3.4 percent in California, and 4.1 percent in New York). The range of tax rates is generally between just above zero up to 8 or 9 percent. The tax is assessed against the payroll of the in-state employer, with the larger employers paying the highest amount of tax. This system is said to discourage layoffs, although how many companies have actually forgone layoffs owing to concern over high unemployment taxes is unknown.

On September 17, 2003, Secretary of Labor Elaine Chao sent a letter to Congress urging the adoption of legislation to stop what she described as "SUTA dumping" (called that because a company is effectively "dumping" its obligation under its state's unemployment tax act). She said that "unscrupulous practices such as transfers of business to shell companies," have resulted in "undermine[ing] confidence in state UI programs by forcing all employers to pay more UI taxes to compensate for the revenue lost as a result of those who avoid taxes" through these practices.

To further justify federal action, Secretary Chao cited a report of the General Accounting Office that found that "fourteen states reported specific SUTA dumping cases within the past three years with revenue losses exceeding $120 million." State laws were said to be inadequate to combat the identified abusive practices.

THE TYPICAL SUTA DUMPING TRANSACTION • Employers with high turnover,

and the corresponding high unemployment tax rates, have with the willing assistance—and encouragement—of various tax consultants, undergone corporate restructurings to qualify for a lower unemployment rate. The two major strategies identified in the GAO study were the purchased shell company and affiliated shell transactions.

The Purchased Shell Company

The purchased shell company transaction involves a newly formed company that purchases an existing business that has a low experienced-rated tax rate. The new company would automatically have qualified for the relatively low, new employer tax rate. The new employer rate, typically 2.5 to 4.1 percent depending on the state, may be even higher than the rate for companies that have had few layoffs over the period of their business lives. Consequently, the purchase of an existing company with an experience rate even lower than the new employer rate could provide significant benefits to the purchasing company.

The Affiliated Shell Transaction

The second prohibited transaction is the creation of the affiliated shell company. Here, a company that has experienced high unemployment tax rates as a result of a series of layoffs, for example, would attempt to reduce its tax rate by the creation of several new corporate entities. These new entities would apply for and receive new tax identification numbers and be classified as "new employers" eligible for the new employer tax rate. The existing company then transfers portions of its employees and payroll to the new entities to reduce the tax paid on that payroll.

No one would argue seriously that a chemical manufacturing company with 3,000 employees and a high unemployment tax rate, for example, that purchases a local flower shop with five employees and a tax rate of .0001, would not be a transaction that the state should have some recourse to revamp. But extremes such as this, when used as the basis for laws of more general application, have the unintended consequence of sweeping the innocent and the guilty with the same broom.

Other Transactions

The two strategies identified by the federal and state authorities are not the only transactions that result in a reduction in the SUTA tax rates. For example, a company may determine to close a certain branch or manufacturing facility. In planning for the closing, the discrete division is often dropped into a new company so that when the layoff occurs, the SUTA tax rate of the surviving parent company is not increased by the effect of the layoffs. The experience-rated tax rate would follow the payroll into the new company, but when the layoff company is liquidated after the layoff has occurred, the state SUTA trust fund would absorb the cost of the unemployment as opposed to the surviving parent company. The Department of Labor concedes that this strategy is not specifically prohibited by the "dumping" statutes. *See*, 69 Fed. Reg. 65,654 (Nov. 15, 2004). However, in response to questions raised by state officials, the Department has suggested interpretations of existing law that may be used to outlaw the "layoff" company by, for example, not recognizing the new company as a separate employer so that the impact on the SUTA rate would fall on the parent company and not be absorbed by the SUTA trust fund.

This example suggests that "all" transactions that result in a reduction in SUTA tax rates to the surviving company are subject to scrutiny and state action. A tax or legal advisor cannot rely upon the strict words of the statute to limit the reach of state labor department auditors who will review these transactions. Any transfer that

results in a reduction of the SUTA tax rate will need to be defended. To suggest extreme caution when these issues are identified in a transaction is not an overstatement.

THE SUTA DUMPING PREVENTION ACT OF 2004 • At hearings of the House Ways and Means Committee in the fall of 2003, graphic testimony on abusive practices that were eroding the unemployment insurance program outraged a bipartisan cross-section of congressional members. The General Accounting Office reported that its auditors had interviewed various accounting firms, tax consulting firms, and employee leasing companies to test their responses to proposed SUTA dumping practices. All of the firms had proposed strategies that would lead to a reduction in state unemployment taxes. In one instance, the auditor was told that it was his "fiduciary obligation" to pay as little unemployment tax as possible. House Ways and Means Committee, *Implementation of the SUTA Dumping Prevention Act of 2004*, June 14, 2005, Serial 109-16.

In August 2004, the Congress passed Public Law 108-295, and the President signed into law the SUTA Dumping Prevention Act of 2004. The Act provided that if a state should fail to enact adequate anti-SUTA dumping legislation, the state's employers would lose their state credit against their federal unemployment tax. (Employers receive a credit toward their federal unemployment tax for the amount of state unemployment tax they pay.)

This statute mandates that states adopt laws requiring that:

- "[I]f an employer transfers its business to another employer, and both employers are …under substantially common ownership, management, or control, then the employment experience attributable to the transferred business shall also be transferred to…the employer to whom such business is so transferred"; and
- "[U]unemployment experience shall not, by virtue of the transfer of a business, be transferred to the person acquiring such business if—(i) such person is not otherwise an employer at the time of such acquisition, and (ii) the state agency finds that such person acquired the business solely or primarily for the purpose of obtaining a lower rate of contributions."

See 42 U.S.C. §503(k)(1). The Act goes on to provide "that meaningful civil and criminal penalties are imposed with respect to (i) persons that knowingly violate or attempt to violate those provisions of the State law…and, (ii) persons that knowingly advise another person to violate those provisions of the State law…."

The Department of Labor provided draft language for state use in meeting the requirements of the Act. The draft legislative language provides:

"In determining whether the business was acquired 'solely or primarily' for the purpose of obtaining a lower rate of contributions, the Commissioner 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 hired for performance of duties unrelated to the business activity conducted prior to acquisition."

See 42 U.S.C. §503(k)(1). If an employer violates the Anti-SUTA Dumping statute, the DOL suggested language calls for the offending employer to be assigned the highest rate assignable for the rate year during which such violation (or attempted violation) occurred, as well as for the three rate years subsequent to the current rate year. If the employer is already at the highest rate for any years, or the increase after the

penalty would be less than a two percent increase, then a penalty of two percent of taxable wages shall be imposed for any such year. If the person is not an employer, he or she shall be fined not more than $5,000.

The Act also calls for each state to establish procedures to identify which transfers or acquisitions of trades or businesses will be considered a violation.

STATE ACTION ON SUTA DUMPING STRATEGIES • By June 2006, virtually every state and the District of Columbia had enacted some version of the required SUTA Dumping statute. Some states are already active in the enforcement of what they view as abusive transactions. North Carolina, California, Texas, Arkansas, and Michigan seem to be the most active states at this time.

North Carolina

North Carolina reported that it was actively pursuing 17 companies with liabilities of $57 million for what it described as "fraudulent transactions" dating to 2002.

A tax alert was issued by the North Carolina Employment Security Commission ("ESC") in 2003 that warned, "[e]mployers engaged in this activity [SUTA dumping] knowingly misrepresent the purpose of the new business activity. … It is illegal…to knowingly make false statements and omit material facts on UI tax documents in order to reduce employment taxes. The ESC will actively pursue and prosecute employers engaged in [SUTA dumping] and has the authority to subpoena records and individuals in its investigations. The maximum penalty is a fine imposed in the Court's discretion and 45 days confinement." https://www.ncesc.com/pmi/news/PressReleases/General/tax-alert_release.pdf.

Texas

Texas identified 30 companies engaged in SUTA dumping, which it is actively pursuing. In one instance, the state is seeking to recover $20 million from a large employee leasing company. In one reported decision dealing with the dumping strategies, a company, Barry GP Inc. filed an unemployment tax refund claim seeking to recover $1.9 million in tax. The company argued that it was eligible for the new employer rate on the payroll of employees transferred to a newly created entity which otherwise qualified for the new employer tax rate. However, the refund was denied by the court of appeals when it discovered that the company had transferred its employees to the new company in two stages, first a transfer of two employees and two weeks later, the other 3,000 employees. The company had qualified for the new rate with the two employees before transferring the rest of the payroll. The court was persuaded that the existing rate of 6.24 percent should follow the payroll and employees whose experience had developed the rate. Texas Workforce Press Release, Feb. 4, 2005, available at www.twc.state.tx.us/news/press/2005/020405press.pdf.

Michigan

Michigan is one of the most active states in the investigation and prosecution of SUTA dumping claims. Michigan recovered $2.4 million in taxes, penalties, and interest from Aramark Corporation. The company, in the midst of a reorganization, had transferred the payroll of eight companies into a single company with a low unemployment tax rate. Whether the "sole or primary" reason for the transfer was the reduction in tax is not clear because Aramark settled with the state without conceding that it had done anything wrong. The head

of the Michigan Department of Labor and Economic Growth was reported to have said in a prepared statement, "[w]hat Aramark was alleged to have done is part of an emerging pattern of companies trying to game the system. The basic idea is to transfer payroll out of an existing company or organization to a new or different organization solely or primarily for the purpose of reducing unemployment taxes." Aramark may have found it more expedient to pay the tax and settle the case than to proceed with the cost and publicity associated with a trial. *See* Howard Fine, *Officials Targeting Companies in Unemployment Tax Fraud*, 27 Los Angeles Business Journal 3 (July 4, 2005) *available at* 2005 WLNR 11671836.

Michigan enacted a SUTA dumping statute effective July 1, 2005 that tracks the federal suggestions in defining the prohibited transactions. But with respect to penalties, the Michigan statute provides that for those who advise their clients to SUTA dump, the current fraud penalty of four times the amount of taxes avoided is added to the up to $5,000 civil penalty imposed on "advisors." The fraud penalty is also added to the penalty imposed on the employer who will also pay at the highest tax rate for a period of three years. Senate Bill 0173, House Bill 4414, Public Act No. 17 of 2005.

California

In California, an investigation by the Employment Development Department ("EDD") has resulted in assessments of $159 million in underpayments against 40 employers in the last two years. Because none of these cases has been litigated, most of the details are private. However, one case that has gone to trial involves the American Employers Group, Inc. an Omaha-based subsidiary of Applied Underwriters Inc, a professional employee organization. This is an employee leasing company that specializes in providing payroll and other HR services to employers. Although court documents show that the company paid $8.2 million in tax for the years 2001 through 2003, the state found that the company engaged in systematic underpayment of its quarterly premiums totaling $12.1 million over the same period. The case is still in litigation. Los Angeles Business Journal, supra.

When the California SUTA dumping law was being debated, the Chamber of Commerce opposed the bill and issued this statement:

"We were concerned because there are very legitimate reasons for mergers and acquisitions that are not done expressly to lower unemployment insurance taxes and some of those companies could find themselves caught up in this…. The key is to go after the companies who are intentionally gaming the system, not those who made an inadvertent mistake or who are using the current tax code to their benefit."

Id.

I have no doubt that some of the companies swept up in the audits that are now being conducted by Michigan, California, Texas, Arkansas, Maine, and other states have, for very legitimate reasons, reorganized and lowered their state unemployment tax rates. They may suffer the same fate as Aramark, however, by being required to pay the tax to avoid litigation when the likelihood of success is not clear.

PLANNING TO AVOID PENALTIES IN THE SUTA DUMPING AUDIT • State employment security departments will, beginning now, conduct audits to enforce their dumping statutes. A pilot program, which will include Virginia, Utah, North Carolina, and Rhode Island, uses software to identify changes in employers—which may indicate a company has engaged in dumping. Criteria that will be isolated for audit include the following:

- Top employers with highest number of employees moved, highest number of negative accounts, most negative account balances with no

taxable wages, and highest employers by growth rate and with highest benefit charges;

- Virginia will schedule for audit any company with the movement of 50 or more employees to another company with a tax rate less than the company that they are moving from;
- Virginia, Utah, and North Carolina will audit all companies that show a high rate of employment growth to determine if this indicates a migration from high to low tax rates;
- Companies that use the voluntary contribution program to reduce their tax rates will be targeted to identify other criteria that may indicate dumping;
- Reductions in payroll will be identified to determine if this is an indication of migration accounts. *SUTA Dumping Experience of Pilot States, A Seminar Sponsored By Utah, Employment Insurance Dept.*, August 4, 2005.

This is an indication of the guidelines that will be used to support the audit programs of the various states. In any reorganization in which smaller subsidiaries are merged into a single company, the migration of payroll will be tracked and the transaction is subject to audit. In any acquisition wherein the acquired company is merged with existing related entities, particularly a newly incorporated entity without an employment history, the transaction is subject to review and state action if no business reason other than the lowering of the SUTA rate can be articulated.

No Safe Harbor

There is no safe harbor that will give insulation from punitive action by the state. Virginia and North Carolina will provide a means for a "preclearance" of a transaction, but it is not clear what criteria will be applied and it is also not clear if a preclearance letter will in fact insulate the company and its legal and tax advisors from the ultimate penalties. It would probably be a good idea to submit a letter to the state department of labor in any state where there is likely to be some effect on the SUTA tax rate. Doing so will put the state on notice of the transfers so that the employer cannot be accused of stealth action and possibly set the stage to get some kind of clearance, thus providing security from state action in the future.

CONCLUSION • Tax reduction has always been a legitimate goal of business planning and entity choice. However, the SUTA tax has to be viewed as an exception. Transactions and restructurings that have the effect of lowering the employer's SUTA liability will raise red flags with regulators, regardless of the employer's intentions. The scrutiny will be rigorous: the taxpayer will be required to show that the transfers that lowered the SUTA tax rate were not "solely or primarily" entered into to save on SUTA taxes. No doubt this standard will begin to gain some clarity in the months immediately ahead as the states conduct their audits and as litigation and settlements with the states are fashioned. However, until more states are willing to commit to some criteria that a diligent taxpayer can rely upon, every transaction should be viewed as potentially problematic.

PRACTICE CHECKLIST FOR

How To Avoid SUTA Dumping Penalties In Mergers And Acquisitions

• The SUTA Dumping Prevention Act of 2004 mandates that the states adopt laws requiring that:

__ "[I]f an employer transfers its business to another employer, and both employers are …under substantially common ownership, management, or control, then the employment experience attributable to the transferred business shall also be transferred to…the employer to whom such business is so transferred"; and

__ "U]unemployment experience shall not, by virtue of the transfer of a business, be transferred to the person acquiring such business if—(i) such person is not otherwise an employer at the time of such acquisition, and (ii) the state agency finds that such person acquired the business solely or primarily for the purpose of obtaining a lower rate of contributions."

• The practical effect of the Anti-SUTA Dumping law is to prohibit the following transactions:

__ The purchased shell company. The purchased shell company transaction involves a newly formed company that purchases an existing business that has a low experienced rated tax rate;

__ The affiliated shell company. The affiliated shell company transaction involves the creation of several new corporate entities by a company that has experienced high unemployment tax rates as a result of a series of layoffs. In this transaction, the existing company then transfers portions of its employees and payroll to the new entities to reduce the tax paid on that payroll.

• States are setting up auditing programs to unearth possible SUTA dumping. Some of the things they look for (depending on the state) include the following:

__ Top employers with highest number of employees moved, highest number of negative accounts, most negative account balances with no taxable wages, and highest employers by growth rate and with highest benefit charges;

__ The movement of 50 or more employees to another company with a tax rate less than the company that they are moving from;

__ A high rate of employment growth to determine if this indicates a migration from high to low tax rates;

__ Use of a voluntary contribution program to reduce tax rates;

__ Reductions in payroll.