IMPLEMENTATION OF THE SUTA DUMPING PREVENTION ACT OF 2004

HEARING

BEFORE THE

SUBCOMMITTEE ON HUMAN RESOURCES

OF THE

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

ONE HUNDRED NINTH CONGRESS

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IMPLEMENTATION OF THE SUTA DUMPING PREVENTION ACT OF 2004

TUESDAY, JUNE 14, 2005

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

The Subcommittee met, pursuant to notice, at 10:04 a.m., in room B–318, Rayburn House Office Building, Hon. Wally Herger (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON HUMAN RESOURCES

FOR IMMEDIATE RELEASE
June 07, 2005
HR–4

CONTACT: (202) 225–1721

Herger Announces Hearing on Implementation of the SUTA Dumping Prevention Act of 2004

Congressman Wally Herger (R–CA), Chairman, Subcommittee on Human Resources of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on implementation of the "State Unemployment Tax Act (SUTA) Dumping Prevention Act of 2004," (P.L. 108–295). **The hearing will take place on Tuesday, June 14, 2005, in room B–318 Rayburn House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Invited witnesses will include representatives of the U.S. Department of Labor and the Department's Office of the Inspector General, State program administrators, and employers. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Subcommittee for inclusion in the printed record of the hearing.

BACKGROUND:

The Unemployment Compensation (UC) program (sometimes referred to as Unemployment Insurance or UI) is a Federal-State 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 SUTA 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 and these rates can change yearly, based on annual computations. In recent years, program experts have grown concerned about unscrupulous business practices such as "shell" transactions involving the artificial manipulation of corporate structures or employees to reduce State tax payments, under a process known as SUTA dumping. Such practices undermine the integrity of the unemployment system, result in the avoidance of proper unemployment tax payments, and unfairly shift costs to other employers.

Following a June 2003 hearing at which the U.S. Government Accountability Office reported that three-fifths of the States believed their laws were insufficient to prevent SUTA dumping, Chairmen Herger and Houghton (R–NY), along with Reps. Cardin (D–MD) and Pomeroy (D–ND), introduced the SUTA Dumping Prevention Act, which was signed into law on August 9, 2004. This law requires States to implement laws to deter employer tax rate manipulation and impose penalties upon those who violate these laws. Guidance on development of these State laws has been provided by the U.S. Department of Labor. In addition to provisions designed to prevent SUTA dumping, the act allows State unemployment programs access to information in the National Directory of New Hires for program integrity activities.

In announcing the hearing, Chairman Herger stated, "Last year an important law was enacted to protect the integrity of the Nation's unemployment benefits system. This law is designed to stop the abusive practice of SUTA dumping by certain employers and to give States additional tools to identify individuals who continue receiving unemployment benefits even after taking a new job. At the hearing, we will get an update on the status of State implementation of these provisions in the SUTA dumping law, and consider any recommendations for further improvement."

FOCUS OF THE HEARING:

The hearing will focus on implementation of the "SUTA Dumping Prevention Act of 2004" (P.L. 108–295).

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record.*" Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Tuesday, June 28, 2005. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item 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. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies 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. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

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.

Chairman HERGER. Good morning, and welcome to today's hearing. Just 2 years ago, This Subcommittee, along with the Oversight Subcommittee, held a hearing on abusive manipulation of State unemployment tax rates. This practice is referred to as State Unemployment Tax Act (SUTA) Dumping. At that hearing we learned that many States lack sufficient laws to prevent SUTA dumping and that unscrupulous employers were wrongly minimizing or even avoiding paying their proper share of State unemployment taxes. This just did not fit with the idea that employer taxes should be based on the experience of their employees in collecting unemployment benefits.

That has been a feature of the unemployment benefits program since its inception in the thirties. 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. Unfortunately, what our investigation found was that some employers were successfully dumping their unemployment costs onto others. They did so by manipulating their corporate structure, sometimes with the help of financial advisors specializing in these tactics. Such actions were hurting the unemployment benefits system, workers, and conscientious employers who played by the rules.

To stop this abusive tax practice and help ensure the Nation's unemployment system worked more efficiently and fairly, we worked on a bipartisan basis in Congress and with the U.S. Department of Labor (DOL) and States. Our legislation had a distinguished list of bipartisan supporters, including our prior Ranking Member, Mr. Cardin, and the gentleman sitting next to me, Mr. McDermott. This legislation was approved unanimously by both the House and the Senate and was signed into law by President Bush in August 2004.

Soon after, the DOL issued guidance and draft legislation to assist States in implementing the new law. Today we will get an update on how the States are doing and what issues we need to consider. Another provision of the SUTA dumping law provides State unemployment benefit agencies access to information in the National Directory of New Hires to help improve unemployment benefits program integrity. Many States already use their own State Directory of New Hires information to identify program overpayments when individuals work and wrongly collect an unemployment check at the same time. Access to the National Directory is designed to help better detect and prevent benefit overpayments.

We also are interested in further proposals to improve the integrity of the unemployment compensation system. Several of our witnesses today have ideas along those lines, which we welcome. Clearly, there is plenty of work to do. For instance, an Office of Management and Budget report released earlier this year noted that in 2004 about 10 percent of unemployment benefits were improperly paid, which resulted in a loss of nearly $4 billion. Needless to say, that money could be better used, including to help workers find new jobs. We need to continue looking for ways to improve the system and make it stronger.

Our witnesses today include representatives from the DOL and the Department's Office of Inspector General (OIG), as well as two

States, an employer, and a researcher. I look forward to hearing all of their testimonies. Without objection, each Member will have the opportunity to submit a written statement and have it included in the record at this point. Mr. McDermott, would you care to make a statement?

[The opening statement of Chairman Herger follows:]

Opening Statement of The Honorable Wally Herger, Chairman, and a Representative in Congress from the State of California

Good morning and welcome to today's hearing.

Just two years ago this Subcommittee, along with the Oversight Subcommittee, held a hearing on abusive manipulation of State unemployment tax rates. This practice is referred to as SUTA dumping.

At that hearing we learned that many States lacked sufficient laws to prevent SUTA dumping and that unscrupulous employers were wrongly minimizing or even avoiding paying their proper share of State unemployment taxes.

This just didn't fit with the idea that employer taxes should be based on the experience of their employees in collecting unemployment benefits. That has been a feature of the unemployment benefits program since its inception in the 1930s.

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.

Unfortunately, what our investigation found was that some employers were successfully dumping their unemployment costs onto others. They did so by manipulating their corporate structure, sometimes with the help of financial advisors specializing in these tactics.

Such actions were hurting the unemployment benefits system, workers, and conscientious employers who played by the rules.

To stop this abusive tax practice and help ensure the Nation's unemployment system works more efficiently and fairly, we worked on a bipartisan basis in Congress and with the Department of Labor and the States.

Our legislation had a distinguished list of bipartisan supporters, including our prior Ranking Member, Mr. Cardin, and the gentleman sitting next to me, Mr. McDermott. This legislation was approved unanimously by both the House and the Senate, and was signed into law by President Bush in August 2004.

Soon after, the Department of Labor issued guidance and draft legislation to assist States in implementing the new law.

Today we'll get an update on how the States are doing, and what issues we need to consider.

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Clearly, there is plenty of work to do. For instance, an Office of Management and Budget report released earlier this year noted that in 2004 about 10 percent of unemployment benefits were improperly paid, which resulted in a loss of nearly four billion dollars.

Needless to say, that money could be better used, including to help workers find new jobs. We need to continue looking for ways to improve the system and make it stronger.

Our witnesses today include representatives from the U.S. Department of Labor and the Department's Office of the Inspector General, two States, an employer, and a researcher.

I look forward to hearing all their testimony.

Mr. MCDERMOTT. Thank you, Mr. Chairman. About a year ago, with your leadership and bipartisan spirit, we produced important

new legislation aimed at curbing an abuse by unscrupulous employers to evade paying their fair share of unemployment taxes. It is not true that nothing good ever comes out of the Congress. The scam is called SUTA dumping, named after the State Unemployment Tax Acts, which provide the pot of money that helps Americans when they lose their jobs.

For those of you who may not know, not the panel but the rest of the audience, unemployment insurance is funded by payroll taxes paid by employers into State unemployment trust funds. These assessments are based on the number of workers who file for benefits; in other words, businesses that lay off more employees pay higher tax rates. Some employers cheat by transferring employees into shell companies created solely for tax evasion. States somehow make up the shortfall, and one way is to shift more of the tax burden to the responsible honest employers. It is not fair and it is not right.

Last year, we required States to enact laws to prohibit SUTA dumping and to penalize the cheaters and advisers who market this unethical, fraudulent behavior. Today we will take our first look at how the States are actually doing. When Congress acted to stop SUTA dumping, we did so under the guise of improving the unemployment program's "integrity." We were really referring to the integrity of employers, and we still have work to do because the shell game is not the only scam used to evade paying their fair share of taxes.

For instance, some employers designate certain workers as independent contractors, a step that denies the worker many benefits, including unemployment comp. A study commissioned by the DOL in 2000 suggested that 80,000 workers may be denied unemployment benefits every year because they are misclassified as independent contractors. Here is what we know: the U.S. Government Accountability Office (GAO) reported that the last time the Internal Revenue Service (IRS) looked into it, an estimated 15 percent of employers had misclassified 3.4 million workers as independent contractors with a net tax loss of $1.6 billion.

Here is what we do not know, however: everything since 1984—because that is the last time the data was collected—for two decades, we have routinely lost billions of dollars and allowed millions of workers to suffer because they were cheated out of benefits they earned. That, Mr. Chairman, I believe is the definition of waste, fraud, and abuse. After two decades in the dark, I thought it was time to turn the light on, so I formally asked Secretary Snow to investigate and provide the Congress with data at least in the same century. Common sense says the problem has grown exponentially over the last 20 years, but there is no sign that the Treasury Secretary will address this issue any time soon. Some companies may be making a honest mistake calling workers independent contractors, but we know many others are doing it deliberately. Millions of decent, hardworking Americans are being victimized at the hands of unethical, dishonest companies, and it is time to level the playing field. We should be concerned about the integrity of the unemployment system. Honest, ethical companies are being forced to pay more to bear the burden of the dishonest companies, and workers are left with nothing at all because the misclassification stops

workers from collecting unemployment benefits when they are laid off. It is time we stand together in This Committee and demand accountability, and it is my hope that you will publicly announce today you are willing to hold a hearing on this matter soon. I think that in the bipartisan attitude we established last year, we ought to be able to do it again. Thank you, Mr. Chairman.

Chairman HERGER. Thank you, Mr. McDermott. Before we move on to our testimony today, I want to remind our witnesses to limit their oral statement to 5 minutes. However, without objection, all of the written testimony will be made a part of the permanent record. On the panel this morning, we have the Honorable Mason Bishop, Deputy Assistance Secretary, Employment and Training Administration at the DOL; Mr. David Clegg, Deputy Chairman for Communications and Chief Legal Counsel, Employment Security Commission of North Carolina; Elliot Lewis, Assistant Inspector General for Audit at the DOL; Larry Temple, Executive Director of the Texas Workforce Commission; and we have a few constituents of the gentleman from Michigan, Mr. Camp, and I will allow you to introduce them.

Mr. CAMP. Thank you, Mr. Chairman, and I just want to take this opportunity to welcome two witnesses from Michigan: Carl Camden, who is president of Kelly Services, and Rick McHugh, an attorney with the National Employment Law Project. I also want to say it is good to have Mr. Camden back almost 2 years to the day after our first hearing on this issue. Again, I want to thank the Chairman for holding this hearing and welcome the Subcommittee Members to the Subcommittee. Thank you.

Chairman HERGER. Thank you. With that, Mr. Bishop, if you would proceed with your testimony.

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

Mr. BISHOP. Good morning, Mr. Chairman. Thank you very much for giving us this opportunity to testify and give you an update on the implementation of the SUTA Dumping Prevention Act of 2004 (P.L. 108–295), as well as highlight several new Administration proposals to strengthen the financial integrity of the unemployment insurance program.

As you know, Federal law requires each employer's unemployment tax to be related to its experience with respect to unemployment, which is usually measured by the unemployment insurance (UI) benefits paid to former workers. Some employers and their tax advisers found ways to manipulate experience ratings so that they paid lower State unemployment taxes than they should have based on their history of laying off workers. This abusive practice, known as SUTA dumping, unfairly burdens employers who play by the rules and end up paying more than they should.

In June 2003, I testified before you to outline the Administration's concerns about SUTA dumping. Since then, much has happened. In September 2003, Secretary Chao transmitted a draft bill to Speaker Hastert. In November 2003, Chairman Herger, former Ranking Member Cardin, current Ranking Member McDermott,

and others introduced H.R. 3463. On August 9, 2004, President Bush signed the Act.

The Act requires States to amend their UI laws to provide for mandatory transfers of experience when employees are moved from one business to another and there is common ownership, management, or control between the two businesses involved; prohibition on transfers of experience when a business is acquired solely or primarily for the purpose of obtaining a low tax rate; meaningful civil and criminal penalties for those who violate or advise others to violate these provisions; and establishment of procedures to identify potential instances of SUTA dumping. All States must amend their UI laws to include these requirements effective either by January 1st of 2006 or July 1st of 2006.

We issued guidance to States that explain the new requirements and provided them with information they needed to draft amendments to their laws. We have been reviewing all draft bills and providing technical assistance to the States. To assist States to identify SUTA dumping, we worked with North Carolina, which is represented here today, to develop software that can be implemented by any State at a minimal cost. While investigation and prosecution of cases is labor-intensive, we believe that these activities will result in State UI tax assessments valued at many times the staff costs involved.

States have reported the following activity as of June 9th: 40 States have either enacted legislation or it is awaiting the Governor's signature; two States have seen bills pass one House of their legislature; three States introduced bills; five States and territories have seen no legislative activity; three State legislatures have adjourned without enacting SUTA dumping legislation. Although we are concerned with the progress of some States, we do believe, overall, the outlook is very good. Mr. Chairman, I do have a map here that we can make available for the record as well and we can handout to Members of the Subcommittee.

[The information was not received at time of printing.]

Even though the new requirements are not yet in effect in most States, attention to this issue has resulted in stronger enforcement of current laws, and some anecdotal information from the States includes the following: California billed 40 employers $158.6 million. Connecticut billed $5.8 million in additional taxes and $3.2 million has already been collected. Pennsylvania uncovered $6.7 million, and Washington has billed over $800,000 to date.

I would also like to update you about the other key component of the Act enabling State UI agencies to gain access to the National Directory of New Hires to quickly detect and prevent payments of UI benefits to individuals who continue to claim benefits after returning to work. Access to this directory will provide States with new hire data from other States and from multi-State employers who report to a single State, and wage and new hire information from the Federal Government. We are currently working very closely with the Department of Health and Human Services, the Social Security Administration, and States to provide access to this directory. We are also running a three-State pilot to determine the most effective methods of accessing and utilizing this data. We believe that investigation of hits discovered from use of this directory

will result in reduced overpayments and substantial savings to the unemployment fund.

Finally, I would like to mention briefly the President's fiscal year 2006 budget proposal to amend Federal law to give States new tools and resources to prevent, detect, and collect benefits that were paid to ineligible individuals; collect delinquent taxes from employers; encourage employer compliance; and upgrade aging State information technology systems. We propose the following:

First, letting States use up to 5-percent of recovered overpayments for additional overpayment prevention, detection, and collection. Second, allowing States to compensate collecting agencies that recover overpayments by permitting them to retain up to 25 percent of the amounts they recover. Third, imposing at least a 15 percent fine on overpayments due to fraud. Fourth, adding delinquent overpayments to debts offset from Federal tax refunds. Finally, requiring States to charge employers for any UI benefit overpayments caused by the employer, except those that result from a good-faith error.

To enable States to update their information technology infrastructure, we propose allowing States to borrow from the unemployment trust fund for this purpose. In conclusion, we are pleased that excellent progress is being made to strengthen the integrity of State UI tax administration, and we are excited about our proposals. We look forward to working with you and answering questions after all the panelists have spoken. Thank you.

[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 morning Chairman Herger and distinguished members of the Subcommittee. Thank you for inviting me to testify. I am pleased to have the opportunity to update you on activities to implement the SUTA Dumping Prevention Act of 2004 (Act). Thanks to your efforts, Chairman Herger and Ranking Member McDermott, and the efforts of the Subcommittee, loopholes in many state unemployment insurance (UI) laws that permit some employers to pay less than their fair share of state unemployment taxes are being closed. In addition, I want to highlight for you a set of legislative proposals designed to improve the financial integrity of state UI programs.

BACKGROUND

Most unemployment benefits are financed by state unemployment taxes paid by employers in every state. Federal law requires 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. As the amount of UI benefits paid to former workers increases, the employer's tax rate increases up to a maximum set by state law. Thus, employers who have a stable workforce with few layoffs have low tax rates while employers with higher turnover generally have higher tax rates. 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. It helps ensure an equitable distribution of costs among employers based on an employer's experience with unemployment. It also encourages employers to stabilize their workforce and minimizes fraud and abuse by providing an incentive for an employer to provide state agencies with information about former workers who quit or were fired for cause.

However, some employers and their tax advisors found ways to manipulate experience rating so that they paid lower state unemployment taxes than they should have based on their history of laying off workers. This abusive practice, known as "SUTA dumping," unfairly burdens employers who "play by the rules" and end up

paying more in unemployment taxes than they should. ("SUTA" refers to state unemployment tax acts.)

SUTA dumping generally occurs in two ways. First, some employers escape their layoff histories (and high tax rates) by setting up shell companies and then transferring some, or all, of their payroll to the shell companies after they have operated for several years with low turnover and earned a low tax rate based on that experience. In the second case, a person who does not currently employ any workers buys a small establishment that has a low unemployment tax rate and the new owner ceases the business activity of the small establishment and commences a different type of business. The new owner then hires many new workers and pays the low tax rate that was earned by the previous owner.

FEDERAL LEGISLATIVE ACTIVITY

In June 2003, I testified before this Subcommittee and the Oversight Subcommittee to outline the Administration's concerns about SUTA dumping and to continue our dialogue on the necessity of enacting legislation to combat this problem. Since then, much has happened. In September 2003, Secretary Chao transmitted a draft bill addressing SUTA dumping to Speaker Hastert, and Chairman Herger, former Ranking Member Cardin, current Ranking Member McDermott and others introduced H.R. 3463 in November 2003. With strong bipartisan support, H.R. 3463 passed the House and Senate in July 2004, and on August 9, 2004, President Bush signed the SUTA Dumping Prevention Act of 2004 into law. Among other things, this Act (P.L. 108–295) requires states to amend their UI laws to provide for:

- mandatory transfers of experience in cases where employees are moved from one business to another, and there is substantial commonality of ownership, management, or control between the two businesses involved;
- prohibition of transfers of experience when the state agency finds that a business was acquired solely or primarily for the purpose of obtaining a tax rate that is lower than the new employer tax rate that would otherwise have been assigned;
- meaningful civil and criminal penalties to be imposed for those who knowingly violate or attempt to violate and for those who knowingly advise another to violate the above provisions; and
- establishment of procedures to identify potential instances of SUTA dumping.
- All states must amend their UI laws to include these requirements effective January 1, 2006 or July 1, 2006, depending on when the state's regularly scheduled legislative session begins and when UI tax rate years begin in that state.

EARLY IMPLEMENTATION ACTIVITY

Four days after enactment of the Act, the Department of Labor (Department) issued guidance to the states that explained the new requirements and the need for states to amend their laws, provided model legislative language for state use in amending their laws, and included a conformity checklist for states that opt to draft their own legislative language. In response to requests for greater clarification and to address new issues, the Department issued additional guidance to the states in October 2004.

To ensure that all state enactments conform to the requirements of the Act, staff at the Department have been reviewing all draft bills and each version of a bill as it moves through a state's legislative process, and has been providing technical assistance to the states including a series of teleconferences with the states to answer their questions. SUTA dumping has been highlighted at a variety of national meetings attended by state officials, and best practices for SUTA dumping detection, investigation, and enforcement will be the major focus of a national conference for state UI tax staff in August.

In addition to legislative changes, the Act requires states to establish procedures to identify transactions that may, in fact, be attempts to dump SUTA liability. To assist states, the Department entered into a cooperative agreement with the North Carolina Employment Security Commission to develop SUTA Dumping Detection System software that can be implemented by any state at minimal cost. This system compares tax data with a variety of criteria that may indicate tax rate manipulation. It was pilot tested successfully by North Carolina, Nebraska, Rhode Island, Texas, Utah, Virginia, and Washington through February 2005, and pending the signing of licensing agreements, the new detection system is ready to be distributed to all interested states. The Department will also provide technical assistance and supplemental funding to states for implementation of the SUTA Dumping Detection

System. While implementation of the SUTA Dumping Detection System software will make identifying potential cases of SUTA dumping more efficient, investigation of potential cases and, in some instances, subsequent prosecution of cases is labor intensive. Although it may require a substantial commitment of administrative resources, we believe that resolution of SUTA dumping cases will result in state UI tax assessments valued at many times the staff costs involved.

STATUS OF STATE LEGISLATIVE ACTIVITY

As of June 9, all states have submitted draft SUTA dumping legislation to the Department for review. States have reported the following activity:

- Legislation has either been enacted or is awaiting the governor's signature in 40 states.
- Bills have passed one house of the state legislature in 2 states.
- Bills have been introduced in the state legislature in 3 states.
- There has been no legislative activity in 5 states/territories.
- Three state legislatures adjourned without enacting SUTA dumping legislation.

Although we are concerned with the progress of the legislative changes in some states, overall, the outlook is good. For example, even though 8 states (including the District of Columbia, Puerto Rico, and the Virgin Islands) have not reported any legislative activity to date, the legislative sessions in many of these states will continue until the end of the year. Thus, there is still sufficient time for these states to act.

RECENT SUTA DUMPING ENFORCEMENT ACTIVITY

Even though the new Federal requirements are not yet in effect in most states, enactment of H.R. 3463 highlighted the SUTA dumping problem, and states have strengthened enforcement of their current laws which prohibit some SUTA dumping activities. Thus, the Act is already having a positive effect. Anecdotal information from states includes the following:

- California assessed 40 employers $158.6 million in underpaid UI taxes, penalties, and interest for SUTA dumping. Twenty-seven of these employers are now reporting properly resulting in $57.6 million in additional tax revenue.
- Connecticut completed 120 investigations of SUTA dumping; $5.8 million in additional taxes has been billed and $3.2 million has already been collected.
- Pennsylvania has completed 76 SUTA dumping investigations, and uncovered $6.7 million in net underreported UI taxes.
- Washington put legislation meeting the new Federal requirements into effect January 1, 2005, and has already assessed over $841,000 in underpaid unemployment taxes from SUTA dumping and has identified approximately 30 additional cases to investigate.

In addition, states that pilot tested the SUTA Dumping Detection System software found a number of instances of SUTA dumping that were legal at the time they occurred but will be illegal under the state laws implementing the Act.

As you know, the Department will study the implementation process, assess the status and appropriateness of compliance by the states, and by July 15, 2007, will submit a report to Congress on these findings including recommendations for any congressional action necessary to improve the effectiveness of the Act.

NATIONAL DIRECTORY OF NEW HIRES UPDATE

I'd like to take a moment to update you about the other key component of the SUTA Dumping Prevention Act of 2004—enabling state UI agencies to gain access to the National Directory of New Hires (NDNH) to quickly detect and prevent certain benefit overpayments. Access to the NDNH provides states with additional data not available in State Directories of New Hires, namely new hire information from multi-state employers who report to a single state and wage and new hire information from the Federal government. We are working closely with the Department of Health and Human Services, the Social Security Administration, and states to determine technical and operational aspects of access to national directory. In addition, we are running a 3-state pilot to determine most effective methods. Preliminary results of the pilot crossmatch to detect potential overpayments attributable to individuals who collect UI benefits while they are in fact earning wages are promising. Complete results of this pilot are expected this summer and will inform development of guidelines for implementation by all states. Although it may require a substantial commitment of administrative resources, we believe that follow-up on all

of the "hits" from the NDNH will result in reduced overpayments and substantial savings to the unemployment trust fund.

STRENGTHENING THE FINANCIAL INTEGRITY OF THE UI PROGRAM

The President's FY 2006 budget includes a set of amendments to Federal law designed to promote and strengthen the financial integrity of the UI program. These amendments will give states access to new tools and resources to: prevent, detect, and collect benefits that were paid to individuals who were not entitled to them, collect delinquent taxes from employers, encourage employer compliance, and upgrade aging state information technology systems. These proposals are key to achieving our goals for the UI program related to preventing, detecting, and recovering improper payments.

A thorough investigation of a small number of weekly payments indicates that states actually detected about 57% of overpayments ($1.1 billion in 2004) we believe they should be able to prevent and detect. They recovered about half of those payments detected. While there are techniques states can use to prevent, detect, and recover these overpayments, a high level of staff effort is involved. For example, potential overpayments detected though computer crossmatches must be verified, individuals must be provided a chance to respond before an overpayment is established, and collection efforts are often lengthy. In order to augment states' current efforts, we developed a set of legislative proposals that will give them additional resources and tools to significantly reduce overpayments, increase the amount of overpayments that are recovered and delinquent taxes collected, and encourage employer compliance.

LEGISLATIVE PROPOSALS FOR OVERPAYMENTS, DELINQUENT TAXES, AND EMPLOYER COMPLIANCE

I will now give you a brief overview of our legislative proposals.

- ***Use of Up to 5% of Recovered Overpayments for Benefit Payment Control Activities***

States' efforts to reduce and recover overpayments are limited by the amount of administrative funding available. Currently, Federal law requires that all recoveries of overpayments be deposited into the state's account in the Unemployment Trust Fund, where they may be withdrawn only to pay unemployment benefits. We propose boosting resources available to states to pursue integrity activities by permitting them to use a portion of those recovered funds to deter, detect, and collect overpayments. States may specify the amounts—up to 5%—of overpayment recoveries to be used exclusively for these purposes. This would provide a new source of funds for states to use to reduce fraudulent and improper payments, giving them the resources they need to expand their efforts.

- ***Allow Collection Agencies to Retain Up to 25% of Recovered Overpayments***

Currently states are reluctant to use collection agencies, primarily because they would have to divert UI administrative grants from other services to pay the collection agency costs. We propose permitting states to allow collection agencies to retain a limited portion—up to 25%—of the fraud overpayments and delinquent employer taxes they recover. States would be expected to first exhaust their established means of collecting overpayments and delinquent taxes before engaging such collection agencies. To prevent abusive or unfair tactics, any state contract with a private collection agency must specify certain safeguards, including that the collection agency follow the Fair Debt Collection Practices Act.

- ***Impose At Least 15% Fine on Overpayments***

All states impose monetary penalties on employers who pay their taxes late. However, most states do not impose monetary penalties on individuals who obtain benefits fraudulently. Penalties can serve as a deterrent to overpayments. We propose requiring states to impose a fine of at least 15% of the overpayment on individuals who defraud the system. States' use of the penalty funds would be limited to additional efforts in deterring, detecting, and collecting overpayments. The State of Washington imposed such a penalty and has seen a considerable increase in overpayment collections.

- ***Add Delinquent Overpayments to Debts Offset by Federal Tax Refunds***

About half of overpayments identified each year are not recovered. Under current law, individuals' Federal income tax refunds are used to offset delinquent child sup-

port obligations, debts owed to Federal agencies, and state income tax debts. We propose adding delinquent UI overpayments to the list of debts that can be offset by Federal tax refunds.

- ***Encourage Employer Response to State Requests***

Information provided by employers is essential in determining the eligibility of unemployed workers who file a claim for UI benefits. However, employers sometimes fail to respond to state queries about the reasons workers are separated from employment, and this can lead to improper UI payments to ineligible workers who quit their jobs without good cause, or were discharged for work-connected misconduct. Despite the administrative and benefit costs created by these mistakes, employers often do not bear any responsibility for the costs of these overpayments. Indeed, after an overpayment is established, states may relieve the employer of those benefit charges. We propose requiring states to impose benefit charges on employers for any UI benefits improperly paid as a result of their late or incomplete responses to state agencies, unless the non-response is due to a good faith error. This will encourage employers to respond promptly to state requests for information about their former workers.

LEGISLATIVE PROPOSAL FOR INFRASTRUCTURE LOANS

An additional legislative proposal is designed to address another UI program need: updating information technology (IT) infrastructure. State UI programs require large and complex benefit and tax processing systems, and service delivery by telephone relies heavily on telecommunications hardware and software. Aging IT systems present a significant risk to states. Older systems are also more difficult and costly to maintain. However, not all states have an effective funding mechanism available to replace and enhance aging technology components.

We propose allowing states to borrow funds from the Unemployment Trust Fund in order to replace/update their UI IT systems, including using new technology to establish linkages with programs that offer reemployment services to UI beneficiaries. This proposal is similar to the current arrangement in that states can borrow from the Unemployment Trust Fund when their benefit accounts become insolvent. Borrowing states would be liable for repayment of principal and interest. By giving states the opportunity to address their IT needs, this proposal will promote timely and accurate benefit payment to unemployed workers, prevention and detection of improper benefit payments, and facilitation of reemployment.

BUDGETARY IMPACT

In aggregate, we estimate that our proposals relating to UI integrity would produce net outlay savings of $4.423 billion over 10 years, of which $3.082 billion is scorable. We also estimate that the proposals would produce indirect tax reductions of $2.856 billion over 10 years.

CONCLUSION

As you can see, we have been working on many exciting and innovative initiatives to improve the financial integrity of the unemployment insurance program. We look forward to continuing to work with you, Chairman Herger, Ranking Member McDermott, and Members of the Subcommittee and Committee in our efforts to make sure that our program has the resources it needs to continue to assist workers who are unemployed through no fault of their own and want to work while minimizing employer taxes.

This concludes my remarks. Thank you for the opportunity to speak with you today. I will be glad to answer any questions you may have.

Chairman HERGER. Thank you very much, Mr. Bishop. Now, Mr. Camden, president and Chief Operating Officer of Kelly Services, Incorporated and, I might mention, someone who was very instrumental in bringing this to our attention. Mr. Camden to testify.

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

Mr. CAMDEN. Thank you. Good afternoon, Chairman Herger and Members of the Subcommittee. It is hard to believe that it has been 2 years since I first had the opportunity to appear before you all, and I think that you probably gathered when I testified I was fairly skeptical about the ability to move quickly and effectively against SUTA dumping. I am pleased that I was wrong and much of my cynicism has been reduced. I applaud the actions of both the DOL and both branches of the Government at solving and taking steps to do this. I have just been nothing but surprised by the speed that you all and the DOL have taken to address this problem.

Significant progress has been made. I not only track your activities through reports like you were given as to what States have collected from what funds, but I am also able to watch through the public filing of staff leasing firms and other firms who have to make allowances in their capital reserves for the anticipated result of State action. I will tell you that they anticipate several tens of millions of more taxes collected and penalties to come.

Now, you asked for a progress report beyond the efforts that you have already made. We look and analyze this problem in three parts. First, we look at the area of loopholes, and a lot of progress has been made in closing the loopholes, and primarily that progress has been made in eliminating games played among commonly owned and controlled entities. The Act does effectively eliminate shell games that employers use when they create subsidiaries, come down to a lower rate, and then transfer their workforce from a high-rated company to one that has a lower tax rate. These intracompany transactions are no longer permitted, and as we watch the State laws, a pretty good job is being done to move along in that area. Employers have the freedom that they need to move people between various business structures, but without being able to pick up SUTA dumping.

Congress also recognized that instead of trying to establish a one size fits all, you gave the States the ability to work off of a minimum set of requirements and then to tailor their requirements, tailor the additional things that they needed to do according to each State law.

Now, somewhere along the wall f<> States missed the point of the flexibility that you were trying to grant them. I worked particularly hard with Michigan and was shocked when I was giving testimony when I heard some of the legislators say, "Well, this is what Congress required us to do. That is all they wanted us to do." I said, "I was at the hearings. I know that was not the case. In Michigan, the Michigan Governor will sign the law that was passed a week from Tuesday. I will be at the signing." She signed it with reservations. We did not close all of the loopholes because all the State of Michigan did was what This Committee minimally required them to do. I think working with the DOL and so on, we will need to work at identifying, as you all have already done, additional loopholes that need to be closed and sending out program letters to the various States. If we merely meet the minimum requirements of the SUTA Dumping Prevention Act and follow the current

guidance, it will not be enough to stop SUTA dumping. There is a lot of cleverness out there, and new loopholes have been identified, ones I was not aware of. I always admire the creativity of some of my colleagues.

I will tell you that tremendous pressure is being put on State lawmakers to preserve these known loopholes that are beyond the minimum requirements that you all established for the States to do. Those loopholes are remaining open more often than we want them to. As I noted, in my home State of Michigan employer groups were divided between those who wanted to stop SUTA dumping completely and those who wanted to limit action to only meet the minimum conforming requirements. Unfortunately, that group managed to win the day there.

During the hearings, one promoter was heard to say, unfortunately not on the record, that he was okay with the legislation because he could still make money off of this. No one has ever had the political nerve yet in any of the battles that we have fought to argue in public that SUTA dumping was good, but there is still a lot of activity behind the scenes. The danger of focusing on the minimum requirements versus truly fixing the problem has now become more apparent, and the biggest hole that we see remaining is in transfers between not commonly owned and controlled entities. In many States it is still possible for an employer to leave behind the experience of a known workforce with a variety of business models there. The Michigan Unemployment Agency recently made public a single incident that cost the trust fund over $10 million, and even though Michigan has passed conforming legislation, you need to understand that the loophole that cost the State of Michigan $10 million is still open. The passed legislation did not close it.

Some States still allow the unemployment experience to be left behind if the transfer was not done "solely or primarily" for the purpose of SUTA dumping. Believe it or not, some employers who have been challenged for dumping have actually managed to successfully argue the transfer was all right because it was not done primarily to avoid SUTA dumping. In fact, one of them publicly stated it was done to dump their workers' compensation costs.

Now, that was not against the law. Obviously, in fact, when we looked at the numbers, they saved a lot more by dumping their workers' comp experience than they did by dumping their SUTA experience, so they were in compliance. So there are still these loopholes that we need to close. What is more, I will tell you, it is a continuous effort because as fast as we close them, people seem to be very inventive at finding other ones.

Moving on to the detection front, I will be brief since I understand David will be providing an update. Just a few quick comments. It has been the easiest of the three areas to address. I applaud the DOL and North Carolina for the efforts they have made. You cannot get to the next step of enforcement without it. I think they have done a very good job at creating detection tools.

Moving on to my personal favorite, enforcement, because it does no good to have the legislation, it does no good to have the detection tools if the States are not aggressive at enforcement. We have got great laws on the books, but I think enforcement is still

sketchy. Many States are doing a stand-up job. Most notably, North Carolina, Michigan, and California agencies should be commended for getting it done. They have devoted a lot of significant State resources to enforcing violated statutes and, again, as I have told you, we see it in terms of 10K disclosures and other SEC filings. It has been limited to a handful of States, and we believe the States aggressively enforcing are an exception versus the norm.

We think that one key problem that could be addressed is the coordination among the States in going after identified dumpers. As I told you when I testified 2 years ago, when people brought proposals to us to engage in SUTA dumping, it was never just do it in State A, B, or C. It was a national plan. A company that dumps in one State is almost certainly dumping in many other States, and what we do not see that we would like to see more of is cooperation between the States at sharing names of companies that they have identified and successfully collected SUTA dumping funds from. They should be sharing those names with other States because almost certainly those problems are existing in other States also. I am a little bit over time. Quickly, one company's perspective. Thank you again for your time and attention. It is an area that I care much about, and again, thank you. I have been amazed at the speed of action. You all have done a great job. I appreciate it.

[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 members of the Subcommittee. I appreciate the opportunity to be with you today, and thank you for holding this hearing to examine the progress in stopping the practice known as SUTA Dumping.

My name is Carl Camden, and I'm the President and Chief Operating Officer of Kelly Services. Kelly is a temporary staffing firm that operates in all fifty U.S. states. Our employees range from secretaries to scientists. Scientists to programmers. Programmers to substitute teachers. Day to day we're actively involved in the hiring, training, and development of over 750,000 workers annually.

As you can expect, we're deeply interested in the health of our workforce development system. Our success in competing in today's global economy is directly impacted by how well we manage the system. Success requires all the key stakeholders . . . Congress, states, workers and employers to be vigilant in making the system the best it can be. Since we work regularly with each of these stakeholders, we're thankful for the opportunity to share our observations.

It's hard to believe it's been nearly two years since I first had the opportunity to appear before you to discuss SUTA dumping. As you recall, those hearings highlighted how employers take steps to disguise their true unemployment experience to avoid paying their rightful share of unemployment insurance taxes. It's a practice that harms employers, workers, threatens state trust fund solvency, and ultimately damages the safety net of our workforce development system.

When I testified, I was somewhat skeptical about our chances to move effectively against SUTA dumping.

But today, I'm pleased to report significant progress has been made. You were dead serious about ending the practice, and as a result of your leadership, the Congress swiftly took bi-partisan action that's made a real difference. I applaud your actions and continued interest in protecting the integrity of the UI program. I must also acknowledge the Department of Labor and many of the states for their significant efforts.

As I testified at the original hearings, there are three parts to the problem:

- Loopholes
- Detection, and
- Enforcement

Progress *has* been made in the area of **loopholes**. The greatest progress has been made in eliminating the games played among *commonly owned and controlled* enti-

ties. The Act effectively eliminates the shell games employers have used when they create a subsidiary, cook down to a low rate, and later transfer their workforce from a higher rated subsidiary to a lower rated one. These intra-company transactions are no longer permitted. Employers are still free to move their employees around for whatever business purpose they have, but now the unemployment experience must also follow.

Consistent with the shared nature of the system, the Congress properly recognized that instead of trying to establish a one-size fits all solution (that ends up turning each state's unique experience rating system on it's head) the legislation should highlight the problem, establish minimum guidelines to get the states going, and leave them the flexibility to solve the problem in ways that best suit their unique circumstances.

Somewhere along the way, too many states and employers have missed the point of the flexibility allowed by the statute. The Act was never intended to be a silver bullet, or a step by step prescription for ending SUTA dumping.

Rather than fully addressing all aspects of SUTA dumping, some states have unfortunately chosen to look at the Act as a set of minimum requirements. Reflecting the attitude, "If that's all we have to do, then that's all we will do." Such an approach leaves loopholes in place.

Merely meeting the minimum requirements of the SUTA Dumping Prohibition Act, and following current guidance by DOL will not fully stop SUTA Dumping. Tremendous pressure has been put on state lawmakers to preserve known loopholes not specifically addressed by the Act. The stakes are simply too high. And those loopholes are remaining open more often than they should. In Kelly's home state of Michigan, employer groups were divided between those who wanted to stop SUTA Dumping, and those who wanted to limit action to meet only the minimum conforming requirements. During final reviews, one promoter was heard to say, "I'm fine with this legislation. I can still make money with this." But even then, no one ever had the political nerve to argue in public that SUTA Dumping was a good thing.

The danger of focusing on the minimum requirements versus truly fixing the problem is now more apparent. As mentioned previously, the biggest hole remaining is in transfers between *not*-commonly owned and controlled entities. In many states it is still possible for an employer to leave behind the experience of a known workforce using various business models. The Michigan Unemployment Agency recently made public a single incident that cost the trust fund over $10 million. Even though Michigan has already passed conforming legislation, the loophole that allowed the damage is still very much alive.

Some states still allow the unemployment experience to be left behind if the transfer wasn't done "solely or primarily" for the purpose of avoiding UI taxes. Believe it or not, some employers who've been challenged for dumping are successfully arguing the transfer was alright because it wasn't done "solely or primarily" to avoid unemployment costs. The primary purpose was to avoid workers' compensation costs!

I don't pretend to know all the loopholes that exist. Promoters have been imaginative, and will continue to figure out creative techniques. When we were here two years ago, only three techniques had been identified. Today there are more than a dozen.

The key part of the solution will be found in requiring the experience of a given workforce to be preserved—regardless of any organizational structure or business model an employer may choose to follow. It shouldn't matter whether the transfer is among commonly owned entities (which the Act addresses) or among not commonly-owned entities (the Act is silent). Why should any distinction be made? The experience is what it is and should never be allowed to be ignored. Dumping is dumping regardless of the ownership structure, and it always leaves all other employers picking up the tab.

Let's move on to the **detection** front. I'll be brief since I understand David Klegg has/will be providing an update. Just a few quick comments. . . .

First, this is probably the easiest of the three areas to address. I applaud DOL and North Carolina for the efforts they've made in developing a tool to make it easier for states to detect dumping. You can't get to the next step of enforcement without it. However, you can't dump without moving large segments of payroll. It's not much more complicated than following the payroll. If you see a company go from $100 thousand in taxable payroll to $100 million . . . something's up. Lack of detection tools has been a lame excuse. Believe it or not, a few states are still in denial, and are asserting that there is no problem in their state. It's extremely important that we continue with the vigorous deployment DOL and NC are leading.

Now to my personal favorite . . . **Enforcement**. You can have the tightest laws on the books, you can have the slickest detection tools in place, everything else can be right . . . but it's all meaningless if you drop the ball with enforcement. Enforcement is the single biggest issue remaining as we move forward. You may recall the promoters' message I shared last time . . . "this is not allowed but go ahead and do it. It's been our experience the state will not enforce." Although the environment in which that statement was made has improved, it hasn't been eliminated. We need to continue to watch this closely as we move forward.

Many states are doing a standup job. Most notably, the North Carolina, Michigan, and California agencies must be commended for "getting it done." They've devoted significant resources to enforcing violated statutes and have had significant results.

Some enforcement efforts have been successful. Based on 10K disclosures and press releases, you'll see multiple assessments have recovered millions. $6 million here, another $2.4 million over there. And over there another $3 million. It starts to really add up. But it's been limited to a handful of states. Those states are the exception versus the norm.

A key problem is that there is little coordination among the states in going after identified dumpers. Every single dumping proposal Kelly received involved a national strategy. If you're going to dump in one state, you're more than likely to follow suit in states B, C and D. But I have yet to see a dumper caught in one state, and then be caught again in a different state. There is no visible cooperation in the tactics and approaches to effective multi-state enforcement. DOL has made efforts to pull states together, and it is essential that those activities continue.

I said earlier I get angry about the enforcement issue. How would *you* react as a businessperson who has to make up for the evasions of other employers? Would you be mad if a frontline state auditor told you their boss told him/her to back off an investigation? "A little fraud never hurt anyone." I'm sure that's the exception, but its happening. In some states there doesn't seem to be the political will for an aggressive enforcement plan. Some states would prefer to pass the conforming legislation, explain the new rules, and move on. Let the past be the past. After all, it's a whole lot easier.

So there you have it—one employer's perspective.

Although I've highlighted some areas that continue to deserve our attention, by no means do I want to leave this Committee with the impression that we're in bad shape. Tremendous efforts have been made over the past two years, and much has been accomplished. Many at DOL, in the states, and in Congress have worked tirelessly to get us this far.

But because of the relentless creativity of the promoters of these schemes, it is critical that we all work together to make sure the effort is sustained. The Congress must remain attentive to the issue. The Department of Labor must continue to share best detection practices, and actively communicate newly identified dumping techniques. State agencies must aggressively detect and prosecute violators. Ethical employers must continue to talk about why the integrity of the system is so important to all stakeholders.

If we all do our part, I'm confident that we can continue toward where we need to be—a UI system where there's no such thing as SUTA Dumping.

Thank you for your time and attention. If you have any questions I will be happy to address them.

Chairman HERGER. Thank you, Mr. Camden. Mr. Clegg to testify.

STATEMENT OF DAVID L. CLEGG, DEPUTY CHAIRMAN FOR COMMUNICATIONS, AND CHIEF LEGAL COUNSEL, EMPLOYMENT SECURITY COMMISSION OF NORTH CAROLINA, RALEIGH, NORTH CAROLINA

Mr. CLEGG. Chairman Herger, thank you so much for inviting me back to talk about North Carolina's continuing fight to protect the solvency of our UI trust fund. Being here on the 2 year anniversary of our first meeting, we do have a lot of preliminary success to enjoy. Two years ago when I was here, I testified about the reality of SUTA dumping in North Carolina. I spoke about how

honest businesses and legislators became angry about the victimization of honest employers and those workers who needed transitional assistance in a complex and challenging economy. In near record time, the North Carolina General Assembly passed legislation demanding that the Employment Security Commission not assign new UI tax account numbers to tax rate manipulators and established felony penalties for SUTA dumping.

Finally, I reported on our first investigative audits and the start of our efforts to develop a fraud detection system based on a computerized analysis program.

Today, my role is that of an accurate reporter, but that task is a lot harder. There is so much more to report on in North Carolina's continuing fight against UI tax fraud. Our initial efforts at investigating SUTA dumping began with five people. That team initially reported their belief that North Carolina may have had as many as 250 major employers who had raided our trust fund of more than $50 million.

The Employment Security Commission has made a decision during this 2 year period to dedicate six auditors to investigate SUTA dumping on a full-time basis. Additionally, two tax specialists, four senior audit supervisors, and one lawyer are committed on a part-time basis. The entire audit staff of our Employment Security Commission is being trained in the identification of SUTA violations because they are becoming increasingly complex.

To date, we have collected $12 million in recovered UI tax. These cases are getting bigger and they are getting harder. Further, some of the employers appear to want to gamble on a judge and jury instead of paying what is owed. Our first cases are headed toward civil litigation. We will handle whatever litigation brings with our own legal staff. We are committed to seeking any needed litigation help from the DOL and Justice and the IRS. Yet I suspect there will be no Federal legal help without Federal legislation.

North Carolina now appears to be operating the most successful UI tax collection program in the 70-year history of our national unemployment insurance system. Back home, we consider our recovery policy to be a simple "firm hand" enforcement policy. With certain allowance for bankruptcy, we expect every employer who engages in SUTA dumping to fully pay the tax that they owe and recognize that their obligation to report their employees' wages as every statutory common law employer is required by State and Federal UI law.

Our enforcement policy has recovered that $12 million from tax schemes that happened before the enactment of Federal legislation in 2004. In fact, the majority of the $12 million is for misconduct that occurred even before North Carolina passed its own legislation in May of 2003. Our tax recovery and enforcement policy is based on North Carolina's understanding and appreciation of the power of basic State and Federal UI law. We are currently amending North Carolina law to conform to the Federal statutory standards. Our strong conviction that our existing law prohibited SUTA dumping does not prevent us from supporting stronger penalties and added safeguards.

Almost all States, including North Carolina, use the same UI Model Act common law definitions of "employer" and "employment"

and "employing unit." Those still valid 1936 era definitions bar employers from engaging in SUTA dumping. The definitions preclude employers from setting up shell corporations, associations, and limited liability companies to evade UI taxes.

It has been suggested that many States will choose to implement SUTA dumping enforcement only prospectively. By doing that, they will be writing off millions of dollars in past losses. Whether that is done by design or out of fear, those write-offs will create an enormous hidden social cost to be borne by the rest of us. Perhaps This Committee will express Congress' sense that the DOL, the IRS, and all of the States have a fiduciary duty, as stewards of the trust fund that protects our economy, to recover this money.

State Unemployment Tax Act dumpers have been deterred by the enactment of this Federal legislation. However, the States will need resources for advanced forensic training of audit and legal staff. The Treasury, FBI, IRS, and the academic community can assist in this effort with your support. While tax attorneys and accountants understand the law, business leaders, who work on their own UI taxes, have been less available for our educational efforts.

Federal legislation is fully supportive of every State's right to seek recovery for past SUTA dumping activity. More importantly, Congress has funded the DOL effort to provide the North Carolina Dumping Detection System to every State. That system was piloted in seven States from June 2004 through April 2005. All the States reported new cases had been identified. While we were developing the program, even after our research, we detected nine more employers with a potential tax liability in excess of $30 million. The largest single employer liability that we detected during the development of our detection system was over $6 million, and we expect to recover that probably within the next 90 days. That detection program works by showing past SUTA dumping. Therefore, the new State users of the North Carolina UI fraud detection system will soon see how violators have established their pattern over several years. State policymakers will then have to decide whether to seek recovery of those past sums. I hope I have raised some issues today with you as confirming to you that Congress did the right thing in addressing this issue with the strength and speed that it did.

[The prepared statement of Mr. Clegg follows:]

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

Chairman Herger, thank you for inviting me back to report on North Carolina's continuing fight to protect the solvency of the unemployment insurance (UI) trust fund by stopping unemployment insurance tax rate manipulation.

We are here on the two-year anniversary of our first meeting. We have all enjoyed great preliminary success in those two years. That success includes the enacting of federal legislation requiring all states to actively combat SUTA and UI tax fraud.

Two years ago, I testified about the reality of SUTA dumping in North Carolina. This included how accountants openly solicited employers to commit UI tax fraud. I used the term fraud then and repeat it now because SUTA dumping is a world of fake employee transfers, sham business structures and false tax returns designed to steal millions of dollars by exploiting experience-based tax rate programs.

I spoke about how honest businesses and legislators became angry about the victimization of honest employers and those workers who needed transitional assistance in a complex and challenging economy. In near record time, the NC General Assembly passed legislation demanding that NCESC not assign new UI tax account

numbers to tax rate manipulators and establishing felony penalties for SUTA dumping.

Finally, I reported on our first investigative audits and the start of our efforts to develop a fraud detection system based on a computerized analysis program.

Today, my role is that of an accurate reporter but that task has become harder. There is so much more to report on North Carolina's continuing fight against UI tax fraud. I will just touch upon those highlights that may best assist the committee and help state administrators understand the tasks, burdens and opportunities they will soon face when the North Carolina UI fraud detection system is made available in their states.

I begin with a brief history. Our initial efforts at investigating SUTA dumping began with five people. This team of three auditors, one tax specialist and one lawyer was given the job of uncovering SUTA violations in North Carolina. They worked cases, reviewed new employer applications and poured over the massive amount of tax history buried in our files. Eventually, the team reported their belief that North Carolina may have had as many as 250 major employers who had raided our trust fund of more than $50 million dollars.

We knew that five people on the first team could not combat SUTA dumping alone. Our staff is currently being downsized from 90 to 80 auditors, and could be augmented if there were federal resources for dedicated SUTA staff at the state level. These auditors have the duty to serve all of NC's 185,000 employers and their 4.2 million employees. They do everything from explaining laws, serving judgments, and resolving independent contractor issues to monitoring the underground economy. NCESC had to decide how to respond to the SUTA dumping threat. Too often, tax enforcement languishes while tax lawyers and advisors devote enormous resources to understand and overcome patterns of enforcement.

Despite our shrinking audit staff, NCESC has made a decision to dedicate six auditors to investigate SUTA dumping on a full-time basis. Additionally, two tax specialists, four senior audit supervisors and one lawyer are committed on a part-time basis, but that does not represent our full commitment. These professionals with a part-time commitment often work full-time on SUTA while some how squeezing in other work. Further, the entire audit staff is being trained in the identification of SUTA violations.

To date, we have collected $12 million in recovered UI tax. The cases are getting bigger and harder. Further, some of the employers appear to want to gamble on a judge and jury instead of paying what is owed. Our first cases are heading towards civil litigation. We will handle whatever litigation brings with our own legal staff. We are committed to seeking any needed litigation help from the U.S. Departments of Labor and Justice and the IRS. Yet, I suspect there will be no federal legal help without federal legislation.

This is not an elegant system, but it has been designed with existing resources and no new staff. Yet, the success of our enforcement program is unmatched. North Carolina now appears to be operating the most successful UI tax collection program in the 70-year history of our national unemployment insurance system. Back home, we consider our recovery policy to be a simple "firm hand" enforcement policy. With certain allowance for bankruptcy, we expect every employer who engages in SUTA dumping to fully pay the tax that they owe and recognize their obligation to report their employees' wages as every statutory common law employer is required by state and federal UI law.

Our enforcement policy has recovered that $12 million from tax schemes that happened before the enactment of federal legislation in 2003. In fact, the majority of the $12 million is for misconduct that occurred even before North Carolina passed its own legislation in May 2003. Our tax recovery and enforcement policy is based on North Carolina's understanding and appreciation of the power of basic state and federal UI law. We are currently amending NC law to conform to the federal statutory standards. Our strong conviction that our existing law prohibited SUTA dumping does not prevent us from supporting stronger penalties and added safeguards.

That power lies in the definitions. Almost all states, including North Carolina, use the same UI model act common law definitions of "employer" and "employment" as well as a common definition of "employing unit." Those still valid 1936 era definitions bar employers from engaging in SUTA dumping. The definitions preclude employers from setting up shell corporations, associations and limited liability companies to evade UI taxes. Finally, even if employers have other reasons for setting up tax-avoidance devices, the employers are not entitled to avoid their common law responsibility as a true UI employer. In other words, North Carolina's enforcement policy is based on the still valid original UI law. All of our recovery efforts are grounded on the basic UI law notion that states have the full legal authority to determine the identity of UI employers regardless of the creation of shell entities.

It has been suggested that many states will choose to implement SUTA dumping enforcement only prospectively. By doing that, they are writing off millions of dollars in past losses. Whether that is done by design or out of fear, those write-offs create an enormous hidden social cost borne by the rest of us. Perhaps, the committee will express Congress' sense that U.S. DOL, the IRS and the states have a fiduciary duty, as stewards of the trust fund that protects our economy, to recover this money. The FUTA law allows federal government to receive an additional ten percent penalty payment on UI tax payments improperly withheld to the states. No federal agency has shown much interest in the collection of those penalties.

SUTA dumpers have been deterred by the enactment of the NC and federal statutes. However, states will need resources for advanced forensic training of audit and legal staff. The Treasury, FBI, IRS and the academic community can assist in this effort with your support. While tax attorneys and accountants understand the law, business leaders, who work on their own UI taxes, have been less available for our educational efforts.

Federal legislation is fully supportive of every state's right to seek recovery for past SUTA dumping activities. Importantly, Congress has funded the U.S. DOL effort to provide the North Carolina SUTA Dumping Detection System (SDDS) to every state. The system was piloted in seven states during the period from June 2004 through April 2005 (Nebraska, North Carolina, Rhode Island, Texas, Utah, Virginia, Washington). Six states reported new cases had been identified for further research or forwarded on to its investigative unit. The system has been readied for distribution to all states, who request it through U.S. DOL. North Carolina will continue to support states that opt to run the SDDS through September 2007. During the pilot of SDDS, North Carolina detected and initiated investigation of nine employers, whose potential tax liability could total in excess of $30 million dollars. The largest single employer liability exceeded $6 million dollars. That detection program works by showing past patterns of SUTA dumping. Therefore, all the new state users of the North Carolina UI fraud detection computer system will soon see how SUTA violators established their pattern of dumping over several years. State policymakers will then have to decide whether to seek recovery of those past sums.

I hope I have raised some challenging issues as well as confirming to you that Congress did the right thing in addressing this issue with strength and speed.

Chairman HERGER. Thank you, Mr. Clegg. Mr. Lewis to testify.

STATEMENT OF ELLIOT P. LEWIS, ASSISTANT INSPECTOR GENERAL FOR AUDIT, U.S. DEPARTMENT OF LABOR

Mr. LEWIS. Good morning, Mr. Chairman and Members of the Subcommittee. Thank you for the opportunity to testify on the work of the OIG, DOL, and the UI program. My name is Elliot Lewis, and I am the Assistant Inspector General for Audit. Today I will highlight some of our recent work in the area of overpayments, discuss our audit recommendations, and outline legislative recommendations for improving the detection and prevention of overpayments. More detailed information is included in my written statement, which I request be included in the record.

The UI program, like many large benefit programs, is vulnerable to improper payments, including fraud. The ETA monitors the accuracy of UI payments and statistically projects the amount of overpayments nationwide through the benefit accuracy measurement, or the BAM. Each State has a benefit payment control unit, or the BPC, that detects and recovers UI overpayments primarily through a computerized match with wage or new hire data.

The OIG has raised concerns in recent years that the overpayment rate in UI has remained relatively flat between 8- and 9-percent per year since 1987. This currently equates to approximately $3.4 billion for calendar year 2004. However, State BPC units currently detect only about a third of the overpayments projected by

the BAM, and only a portion of that will actually be collected, making prevention and early detection of overpayments all the more important.

Mr. Chairman, our efforts to combat UI overpayments include audits, criminal investigations, and cooperative education with the Department and the States. In response to concerns about continued overpayment problems in UI, the OIG audited the Department's Benefit Accuracy Measurement. We also conducted an audit to determine whether the use of new hire data is more effective and efficient than traditional cross-match methods for detecting overpayments.

Our 2003 BAM audit recommended that the Department analyze the vast amount of data collected through the BAM to identify trends or patterns of errors that result in overpayments and address systemic problems. The OIG also estimated that expedited connectivity to State new hire directories throughout the country could save the Unemployment Trust Fund as much as $428 million annually through a reduction in overpayments. We also found and ETA acknowledged that elevating UI overpayments to a core performance measure should result in identifying and correcting systemic problems.

We also conducted an audit of BPC methodologies, specifically State access to their own State new hire directories. We found that despite the benefits of cross-matching with their own State new hire data, 12 States had not done so. In those States that had implemented this type of cross-matching, we found the use of State new hire data was significantly more effective in identifying overpayments than cross-matching benefits against wage data.

As a result, Mr. Chairman, we made several recommendations. Among them is a recommendation for employers to report the first day of earnings for all new hires. Current reporting requirements do not provide the data needed for new hire detection to precisely identify overpayments. Defining and requiring employers to report the specific date that new hires begin earning wages would increase the screening accuracy of new hire detection, thus reducing resources expended on identifying and investigating false hits.

Additionally, we recommended that DOL continue to provide technical assistance and resources to the States that are not currently using new hire data. We further recommended that that DOL encourage and facilitate use of the national directory. To this end, ETA has awarded $18 million to the States for UI integrity-related projects and is currently working with State and Federal agencies to explore how best to use the national directory.

Mr. Chairman, as I mentioned earlier, UI overpayments occur for a number of reasons, including fraud. The BAM estimated potential fraud-related overpayments in calendar year 2004 at $868 million, or approximately 25 percent of projected overpayments. The OIG investigations have identified several methods used to defraud the UI system that have resulted in substantial losses to the Unemployment Trust Fund. Of greatest concern are identity theft schemes, which involve the use of stolen identities to apply for UI benefits. One key way for DOL to mitigate UI fraud is to make States more aware of its dangers, so we continue to partner with

ETA to provide training to states on fraud prevention and detection.

Mr. Chairman, in my full statement, I discuss two legislative recommendations that we believe will improve detection and prevention of overpayments. Among these is granting OIG and the Secretary of Labor statutory authority to easily and expeditiously access State UI wage records, Social Security wage records, and information from the National Directory of New Hires.

In conclusion, Mr. Chairman, we believe that overpayments can be reduced by better use of existing data, including data obtained from the BAM, the UI performance measurement system, and the new hire cross-match. We also believe that granting DOL and the OIG access to the National Directory will facilitate our work to detect and deter overpayments in the UI program. I appreciate the opportunity to testify before you, and I would be happy to answer any questions you or any Member of the Subcommittee may have.

[The prepared statement of Mr. Lewis follows:]

Statement of Elliot P. Lewis, Assistant Inspector General for Audit, Office of Inspector General, U.S. Department of Labor

Good morning Mr. Chairman and members of the Subcommittee. Thank you for the opportunity to testify on the work of the Office of Inspector General (OIG), U.S. Department of Labor (DOL), in the Unemployment Insurance (UI) program. My name is Elliot Lewis and I am the Assistant Inspector General for Audit. Today I will highlight some of our recent work in the area of overpayments, discuss our audit recommendations, and outline our legislative recommendations for improving the detection and prevention of overpayments.

BACKGROUND

By way of background, the Department of Labor's UI program is a Federal-state partnership and is DOL's largest income maintenance program. While the framework of the program is determined by Federal law, benefits for individuals are dependent on state law and administered by State Workforce Agencies. Like many programs of this magnitude, the UI program, which was designed to assist those who are in between employment through no fault of their own, is vulnerable to improper payments including fraud.

The Employment and Training Administration (ETA) monitors the accuracy of UI payments made to claimants and statistically projects the amounts of overpayments nationwide through the benefit accuracy measurement (BAM). Moreover, each state has a benefit payment control (BPC) unit that detects and recovers UI overpayments through a variety of methods, primarily through a computerized match between either employer wage records or new hire data and records of benefits paid to claimants.

The OIG has raised concerns in recent years about the magnitude and consistency of the overpayment rate in UI. Since 1987, the estimated overpayment rate has remained fairly flat, between 8% and 9% per year. BAM projections for calendar year (CY) 2004 estimated overpayments at $3.4 billion. However, state BPC units currently detect only about one third of the overpayments projected by BAM. For CY 2004, BPC units detected only $1.1 billion for possible collection. Only a portion of the $1.1 billion will actually be collected due to various difficulties exacerbated by delayed detection. The low collection potential demonstrates the importance of prevention and early detection of overpayments.

AUDIT OVERSIGHT

Mr. Chairman, our efforts to combat UI overpayments include audits of the UI program, criminal investigations, and cooperative education with DOL and the states. Our recent audit work has focused on receipt of unauthorized benefits, also referred to as overpayments. In response to concerns about continued overpayment problems in the UI program, the OIG audited the Department's Benefit Accuracy Measurement. We also conducted an audit to determine whether the use of new hire data is more effective and efficient than traditional cross-match methods for detecting overpayments.

Benefit Accuracy Measurement (BAM) Program Audit

Our 2003 BAM audit recommended that the Department analyze the vast amount of data collected through the BAM to identify trends or patterns of errors that result in overpayment and address systemic problems. In that audit, the OIG also estimated that expedited connectivity to the state new hire directories throughout the country could save the Unemployment Trust Fund (UTF) an estimated $428 million annually through a reduction in overpayments. The Department agreed with this finding but estimated a maximum potential savings of $139 million. We also found, and ETA acknowledged, that elevating UI overpayments to a Core Performance Measure should result in: increased oversight at the state and Federal level, identification of systemic problems, and corrective action plans for states with unacceptable performance.

Unemployment Insurance Benefit Payment Control (BPC) Performance Audit

We also conducted an audit of BPC methodologies, specifically state access to their own state new hire directories. Just prior to issuing the BPC report, the SUTA Dumping Act of 2004 (P.L. 108–295) was enacted which granted state UI agencies access to the National Directory of New Hires.

Our audit found that despite the benefits of cross-matching with their own state new hire data, 12 states, for a variety of reasons, had not implemented cross-matching to their state new hire directory. In those states that had implemented a state new hire directory cross-match, we found that State Workforce Agencies' use of state new hire data was significantly more effective in identifying overpayments than the traditional technique of cross-matching UI benefits against wage records reported by employers. The seven state UI programs we audited that were using the state new hire detection method identified 41,404 overpayments, compared to their wage/UI benefit cross-match that identified 29,872 overpayments.

As a result of this audit, Mr. Chairman, we made several recommendations to enhance the effectiveness and efficiency of using new hire data to detect overpayments. Among them is a recommendation for employers to report the first day of earnings for all new hires. Current reporting requirements do not provide the data needed for new hire detection to precisely identify UI overpayments. As a result, the method identifies a significant number of cases that, upon further review, do not involve payment of ineligible benefits. Defining and requiring employers to report the specific date that new hires begin earning wages would increase the screening accuracy of new hire detection, thus reducing the resources expended on identifying and investigating "false hits."

Additionally, we recommended that DOL continue to provide technical assistance and resources to the state UI programs that are currently not using new hire detection to initiate and/or complete plans for implementation. We further recommended that DOL encourage state UI programs to access the National Directory and coordinate efforts with the U.S. Department of Health and Human Services and the state UI programs to accomplish this. In response to our recommendation, ETA informed the OIG that during FYs 2003 and 2004, a total of $18 million was awarded to states for UI integrity related projects, of which, over one-third was awarded for benefit payment control cross-matches, including implementation or enhancement of new hire detection systems. ETA is currently working with state and Federal agencies to explore how states can best use the National Directory. ETA has indicated that it will be issuing a report this summer on the results of a pilot to test the value of connecting to the National Directory.

NATIONAL DIRECTORY OF NEW HIRES

Based on what we have learned through our audit work, Mr. Chairman, the OIG is of the opinion that using new hire data is a better method to identify over payments than the more traditional method of cross-matching UI claims against employers' wage records. The traditional method relies on data that is reported quarterly, whereas new hire data is generally reported by employers within 20 days. The National Directory is the most comprehensive list of new hires because it consolidates all state data and includes Federal employment data and data on multi-state employers who may report to only one state. If fully implemented and utilized by the states, the National Directory cross-match should result in earlier detection of overpayments, reduce overpayment dollars, and increase the chance of overpayment recovery.

INVESTIGATIONS

Mr. Chairman, as I mentioned earlier, UI overpayments occur for a number of reasons, some of which are fraudulent. The BAM estimated potential fraud-related overpayments for CY 2004 at $868 million or 25.5% of projected overpayments. OIG investigations have identified several methods used to defraud the UI system that have resulted in substantial losses to the UTF. Of greatest concern are identity theft schemes, which involve the use of stolen identities to apply for UI benefits. These cases often involve non-traditional organized crime groups, and are therefore broader in scope and more costly to the UI program than individual claimant fraud schemes of the past. One such case in California involved a Mexican non-traditional organized crime group that systematically filed thousands of fraudulent claims in four states. Our investigation ended this fraud scheme, which involved over 15,000 stolen identities and identified a total of over $58 million in losses.

One key way for DOL to mitigate UI fraud is to make states more aware of its dangers and of typical fraud schemes, such as identity theft or creation of fictitious companies to obtain UI benefits for alleged former employees. We continue to partner with ETA to provide training for state UI personnel on fraud prevention and detection.

LEGISLATIVE RECOMMENDATIONS

Mr. Chairman, there are two legislative recommendations that we believe will improve detection and prevention of overpayments. First, to reduce overpayments and for program evaluation purposes, we believe that the OIG and the Secretary of Labor should be granted statutory authority to easily and expeditiously access state Unemployment Insurance wage records, Social Security Administration wage records, and information from the National Directory.

Secondly, we recommend that the Personal Responsibility and Work Opportunities Reconciliation Act of 1996 be amended, or new legislation be introduced, to require employers to report a new hire's first day of earnings and provide a clear, consistent, nationwide definition for this date. Use of a specific, uniform date of wage earning would allow for increased efficiency in cross-matching dates of benefits received with dates of reported earnings.

CONCLUSION

In conclusion, Mr. Chairman, we believe that overpayments can be reduced by better use of existing data, including data obtained from the BAM, the UI performance measurement system, and the new hire cross-match. We also believe that granting DOL and the OIG access to the National Directory will facilitate our work to detect and deter overpayments in the UI program. We expect that as the states enact their own legislation in compliance with the SUTA Dumping legislation, and as the Department responds to our recent audit recommendations, there will be a beneficial impact on the reduction of overpayments. We will continue to follow up with the Department on the status of our recommendations.

I appreciate the opportunity to testify before you and I would be happy to answer any questions you or any member of the Subcommittee may have.

Chairman HERGER. Thank you, Mr. Lewis. Now Mr. Rick McHugh, Staff Attorney for the National Employment Law Project.

STATEMENT OF RICHARD W. MCHUGH, STAFF ATTORNEY, NATIONAL EMPLOYMENT LAW PROJECT, DEXTER, MICHIGAN

Mr. MCHUGH. Thank you, Mr. Chairman. As you mentioned, I am a staff attorney with the National Employment Law Project (NELP). We are a research and advocacy group that focuses on dislocated and jobless workers. For the past several years, we have been monitoring employer activity that harms the integrity of the unemployment insurance financing system, include SUTA dumping. In the past year, we have worked closely with some State administrators, State legislators, and legislative staffers, as well as

interested labor organizations and State policy projects, concerning the implementation of the SUTA Dumping Prevention Act of 2004.

Before I get into the details of my testimony, I want to thank the leadership offered by the Chairman and the Subcommittee in requiring that States tackle SUTA dumping. I think we have already heard some testimony this morning about the kind of resistance that the States are facing, and I am pretty sure they would not have started down the road they have started down without your requiring it.

I would also say that my number one conclusion from our study of State actions so far is that the lion's share of the State activity has been to merely comply with what the guidance from the DOL has said that your legislation required. States that have attempted to go further than the minimum requirements to comply with the SUTA Dumping Prevention Act have uniformly met opposition, and in nearly every case that opposition has been successful. We at NELP have reviewed the text of 26 of the enacted and proposed State SUTA dumping laws, and we have come to the conclusion that one of the most important loopholes that could be addressed that is not required to be addressed under the legislation that you passed last year involves the professional employee organizations.

Now, Mr. Camden was polite. He calls it "organizations that are not under the common custody, control, and management of other organizations." Basically what these staffing services and employee leasing firms do is, if I run a widget factory, I can take all my employees and basically move them over to the Personal Employment Organization (PEO), and the PEO has a lower experience rate because, generally speaking, they can find placements very rapidly. They would never have to lay off somebody. Even if they were working at that factory, they would have another factory they would move them to as opposed to laying them off. So generally their experience rate is lower. If it is not, probably this transaction would not be taking place because the way the employer is able to pay the fee is basically the money they are going to be saving on the taxes.

Now, the PEO's and their allies do not want this activity to be characterized as SUTA dumping, but if anything, the legislation you have passed has increased the economic incentives for this to occur because you have eliminated other avenues that the firms can use to SUTA dump, and so that is going to, I think, increase the chances that the PEO loophole will be exploited even more so than what we have seen.

I wanted to just speak generally about the idea of integrity and what our priorities should look like. I think we have heard from the Administration about their concerns, which are mostly about overpayments to workers. I would just like to point out that the Administration also is proposing in its budget to eliminate $750 million of spending from the Employment Service, which is an agency that is designed to get workers back to work faster and have them be on benefits for less time. They propose no money for additional auditors or other resources for the States to implement the SUTA Dumping Prevention Act. They have not proposed that the Federal enforcement agencies work with the State agencies, and the State agencies have a mandate that they get to work with

their State treasuries and other tax enforcement agencies within the States.

If we want to talk about integrity, I think that is fine, but we have to also understand that wrongfully denying a benefit or underpaying a benefit is just as important as overpaying a benefit. So when I hear the OIG testify about overpayments, I would like to also have them put that in the context of the fact that benefits are frequently wrongfully denied, so that we do take a two-sided, across-the-board approach to integrity in unemployment compensation and not give the impression that the problem is jobless workers trying to cheat the system. Most of the fraud that is going on that the OIG testified about dealing with identity theft, that is not jobless workers that are out there getting a false identity. That is just criminals who are getting a false identity so they can draw the unemployment when they should not draw it. So I do want to, since I am the worker advocate on the panel, speak on that the great majority of jobless workers are just as interested in getting a job as all of us would be if we did not have one, and they are as honest as people with jobs. Thank you.

[The prepared statement of Mr. McHugh follows:]

Statement of Rick McHugh, Staff Attorney, National Employment Law Project, Dexter, Michigan

Introduction

Mr. Chairman and members of the Subcommittee, my name is Richard W. McHugh. I am a staff attorney with the National Employment Law Project. National Employment Law Project is a nonprofit law and policy organization dedicated to research and advocacy on issues of concern to low wage and jobless workers, including unemployment compensation. We thank the Chairman for his invitation to offer our testimony on implementation of the SUTA Dumping Prevention Act of 2004 (P.L. 108–295).

About National Employment Law Project

For over 30 years, National Employment Law Project (NELP) has served as the leading voice of jobless workers, with an emphasis on policies and practices that impact low wage and part time workers. NELP research has identified and supported wider use of alternative base periods to qualify more low wage workers for unemployment benefits as well as policies that assist jobless workers facing work and family conflicts. NELP also serves other low wage workers, including immigrants, day laborers, and nonstandard workers.

My own experience with unemployment compensation includes nearly 30 years of legal representation and advocacy on behalf of jobless workers. In addition to handling hundreds of administrative hearings and court appeals, I have testified before this Subcommittee and in other Congressional hearings, as well as before the Advisory Council on Unemployment Compensation and state legislative committees. I hope that this experience and perspective can assist the Subcommittee in its assessment of how implementation of the SUTA Dumping Prevention Act of 2004 has progressed to date.

For the past several years, NELP has monitored employer activities that harm the integrity of unemployment insurance financing, including SUTA dumping. In the past year, we have worked closely with some state administrators, state legislators and staff members, as well as interested labor organizations and state policy projects concerning state SUTA dumping legislation. My testimony today will focus on what we have learned over the last year regarding the challenges that remain in attempts to combat SUTA dumping.

Overview of Progress To Date on SUTA Dumping

To begin, we would like to recognize the leadership offered by the Chairman and this Subcommittee in requiring that states tackle SUTA dumping. The Subcommittee's 2003 hearing and accompanying General Accountability Office study focused wider attention on this significant issue. A legislative initiative led by Chairman Herger and other members of this Subcommittee then resulted in bipartisan pas-

sage of the SUTA Dumping Prevention Act last summer and its signing by President Bush in August 2004. Our study of states' reactions to new federal requirements set by the SUTA Dumping Prevention Act shows that the Act has furnished an important launching point for state activity.

As this Subcommittee knows, SUTA dumping involves manipulation of state experience rating rules that enables employers to dodge unemployment insurance taxes rates established by their past claims records in order to obtain lower UI tax rates. In its June 2003 hearing, this Subcommittee heard Government Accountability Office testimony that fourteen states had identified SUTA dumping schemes that cost state unemployment trust funds an estimated $120 million in lost revenues. Most states reported to GAO that they believed their state laws were inadequate to address SUTA dumping schemes. Three out of four accounting firms interviewed by GAO investigators encouraged GAO personnel posing as employers to engage in SUTA dumping as a means to avoid UI taxes.

Since 2003, new evidence has confirmed Congress' determination that SUTA dumping is a dishonest business practice that hurts unemployment insurance finances. Michigan recently recovered $2.4 million from Aramark Corporation in its first anti-SUTA dumping action. Other states' experience is similar: Connecticut has discovered a loss of $4 million since October 2003, and has dozens of enforcement cases pending. North Carolina has collected $9 million in just 12 cases, with 250 SUTA dumping cases still pending in that state alone. In short, with additional resources and followup SUTA dumping legislation promises to assist states in collecting added UI contributions and deterring further violations.

Given the variation of state UI laws in terms of their experience rating and rate transfer provisions, the SUTA Dumping Prevention Act necessarily dealt with technical issues involving SUTA dumping in a general manner, focusing on two SUTA dumping practices that had been clearly identified at the time. To review, the Act required that "shell" entities under common ownership, management, or control were barred from obtaining a lower experience rate by mandating the transfer of the existing firm's rate to the shell company. Second, the Act required that in cases of sham transactions involving acquisitions "solely or primarily" for the purpose of gaining a lower UI tax rate, no experience rate transfer would occur.

While specifically targeting two types of SUTA dumping, there was no indication that Congress thought that the 2004 Act should be read as more than the beginning response to SUTA dumping. Indeed, in its initial guidance to states, the Department of Labor correctly termed the 2004 federal law a "nationwide minimum standard for curbing SUTA dumping." Despite the fact that states have power to go farther than the steps mandated by federal law, there are very few examples of that actually happening so far. Most states are approaching the mandates of the SUTA Dumping Prevention Act as a typical piece of UI conformity legislation. In other words, they see the Act as prescribing certain state action and they are taking only those actions. As a result, the lion's share of state SUTA dumping laws that have passed so far only contain elements required by the Department of Labor's program letter, and in some cases, even fall short of these minimum requirements.

A year after enactment of the federal law, we have learned much more about SUTA dumping practices and about the policies that will be most effective in addressing SUTA dumping in a comprehensive manner. In addition, NELP has reviewed the texts of 26 enacted and proposed state SUTA dumping laws, and we have assisted in state campaigns in several states. Uniformly, states that have sought to go farther than the minimum requirements of federal law have faced significant resistance during the current round of SUTA dumping legislation. For that reason, further federal action is required if states are going to have all the tools required to adequately solve the SUTA dumping puzzle as it is now more fully understood.

In summary, our study of state SUTA dumping legislation finds that those aspects of SUTA dumping that were directly targeted by federal law are now largely being addressed by state legislation. Yet, what we know about SUTA dumping indicates that SUTA dumping is an evolving phenomenon and requires new tools if we want to address all its aspects. We recommend the following actions.

Recommendation 1: Close PEO Loophole

First, we recommend the prompt elimination of an existing loophole in SUTA dumping law. As currently written and applied, the SUTA Dumping Prevention Act does not prevent a common employment arrangement used by employee leasing and staffing services. These firms, which we can group together under the name of professional employee organizations (PEOs), continue to offer employers a lawful means to engage in SUTA dumping in the majority of states. States using the model language provided by the Department of Labor in implementing the Act will not cover

the practice of firms leasing their employees through a professional employee organization in order to rid themselves of their unemployment insurance experience rate.

PEOs, for a fee, take workers onto their payroll and essentially sell or lease them back to an employer. Under the arrangement, employees are "dumped" from an existing business to a PEO, but since the PEO and the firm are not under "common ownership or control," the PEO would not be forced to combine its experience rate with the existing firm under the current federal law. In addition, PEOs are not usually engaged in sham transactions "solely or primarily" for the purpose of gaining a lower UI rate. Thus, under the model SUTA dumping language used in nearly all states passing legislation so far, firms are able to avoid their UI experience rate by utilizing a PEO. (A number of states already require PEOs to report wages by employer account numbers, rather than under their own experience rated account. This sometimes means that wages are associated with the employer using the PEO and taxed at the applicable rate, insuring that the PEO relationship is not used to SUTA dump. In other cases, even though PEOs report wages by employer account numbers, state law permits them to serve as the employer for purposes of UI.)

The business of using a PEO is large and growing. Two million workers nationwide work through PEOs, which are operated by some of the nation's biggest staffing firms as well as numerous smaller operators. The 2002 Economic Census results reported PEO gross revenue more than doubled from $24 billion in 1997 to $55 billion in 2002. Staffing Industry News projected 2003–2005 PEO revenue would grow 8 percent each year.

SUTA dumping through PEOs is very lucrative for employers that engage in it. Kelly Services has estimated it could have saved $30 million in UI taxes in one year if it had engaged in SUTA dumping. Because of the competitive disadvantages faced by Kelly Services because it has refused to adopt SUTA dumping, Kelly has been a major proponent of SUTA dumping legislation. Ironically, as other SUTA dumping schemes are cut off by implementation of the SUTA Dumping Prevention Act, PEOs may become a more attractive option to firms looking to artificially lower their UI tax rates.

States can effectively address the issue of SUTA dumping by employers using PEOs by covering all transfers of employees from one business to another in their bills. We believe that Pennsylvania, in its recently-passed SB464, is the only state that has addressed PEOs in implementing the SUTA Dumping Prevention Act. A New Jersey SUTA dumping bill addressing PEOs is still pending. Proposals that would have addressed this issue were amended out in Michigan, Minnesota, and Washington.

Michigan's experience in attempting to regulate PEO transactions in its SUTA dumping implementation illustrates the difficulties of states acting in the absence of a federal mandate. In Michigan, the state agency negotiated a bill on SUTA dumping with employer organizations. The negotiated bill included a requirement that PEOs report wages by the client employer's account and called for taxes to paid under the client employer's rate. Ultimately, the issue of regulating PEOs in the context of SUTA dumping became a major stumbling block, with some business organizations agreeing that PEO transactions should be included, and others preferring a law that only addressed those forms of SUTA dumping required by the SUTA Dumping Prevention Act. In the end, PEOs and their allies succeeded in limiting Michigan's SUTA dumping implementation law to only those elements required by federal law. PEO representatives characterized this as a "victory" that "preserves a PEO's ability to report unemployment insurance under the PEO's account and rate." Of course, reporting employee wages under the PEO's account means that the employer using the PEO has dumped its existing UI experience rate.

Given the nearly uniform inability of states to address PEOs in their implementation of the Act, we believe that supplemental legislation or Department of Labor regulations will be required if the use of PEOs for SUTA dumping is going to be addressed in all states. Client-level reporting of wages, which associates the wages reported with the appropriate employer's account and requires payment of UI taxes based upon the client firm's tax rate is the best solution. Closing the PEO loophole will be challenging at the federal level, but our experience indicates that unless federal rules require the states to act, they will not move forward on their own to address the role of PEOs in SUTA dumping.

Recommendation 2: Fix Penalties for Sham Transactions By Non-Employers

In providing guidance to states in implementing the SUTA Dumping Prevention Act, we believe that the Department of Labor erred in one significant respect. In the case of a sham transaction involving the acquisition of a business by a non-employer solely or primarily for the purpose of obtaining a lower UI tax rate, Labor

drafted its model legislation to provide that these persons shall be assigned a state's "new employer" tax rate. In some cases, a new employer rate will still provide an offending employer with a substantially lower UI tax rate, so Labor's approach is not wholly effective in addressing SUTA dumping.

Sham transactions involve purchases of experience-rated businesses with low UI rates. Employees of another higher-rated employer are then transferred to the lower-rated business. Under Labor's approach, a purchaser that is not an existing employer can get a generally low "new employer" rate and effectively operate a higher tax-rated firm under the acquired account, even if the purchaser is caught and subjected to the "new employer" rate penalty. And, the purchaser can still SUTA dump and save on UI taxes, at least in the short term. Under the model law language non-employer purchasers engaged in SUTA dumping would get the same tax rate as any other law-abiding new employer.

New employer rates vary widely from state to state. For example, the "new employer" rate in South Dakota is 1 percent of taxable wages, but in New Mexico it is the maximum rate of 5.4 percent. As a consequence, because both states' bills have adopted the Labor Department model language, a SUTA dumping employer in South Dakota will get a penalty rate of 1 percent, and in New Mexico, the employer might get a rate of 5.4 percent. In New Mexico, this result is obviously a penalty rate, but that is not the case in South Dakota. A better approach would apply the maximum tax rate, plus two added percentage points, just as the model bill proposes for existing employers who make a transfer to evade the provisions of the law.

Vermont is the only state of which we are aware that effectively penalizes persons caught buying an existing unemployment account to start a new business under that lower tax rate. In Vermont, the non-employer acquiring the existing firm suffers a higher penalty than the new employer rate. Under H0071, such businesses are taxed at the highest tax rate until they have been in business long enough for accurate calculation of their experience rating.

Recommendation 3: Ensure Effective SUTA Dumping Penalties

The SUTA Dumping Prevention Act requires states to adopt "meaningful civil and criminal penalties" with respect to SUTA dumping. The Department of Labor recommended that SUTA dumping firms be subject to the maximum tax rate (or a 2 percentage point increase, whichever is higher) for four years. Unfortunately, nearly half the state laws we surveyed are proposing penalties that are weaker than Labor's model bills.

The Department of Labor draft SUTA dumping bills suggests that employers who are caught "knowingly" violating the SUTA dumping law should be subject to maximum UI taxes allowable under a state system for four years. If the employer is already paying the maximum rate, the Labor Department suggests that the penalty be the maximum rate plus 2 percentage points. Most of the state bills we have reviewed adopt this approach. However, at least nine states have penalties that are lower than Labor Department's suggested penalty, and that do not meet the standard of the federal bill that penalties be "meaningful." Oklahoma's bill provides for 10 percent of actual taxes due for one year, rather than the four years maximum tax rate suggested by Labor's model bill. Some bills, such as Michigan's, do not add any penalties to those already in state law.

We recommend that Labor take a more active role in reviewing and approving state SUTA dumping bills, and advise states that have not followed Labor's model penalties that they must do so.

A second concern regarding penalties is inadequate civil penalties for "non-employers." The Labor Department model imposes a maximum $5,000 penalty on "persons" (generally including those who have no "employees" or those who are not existing employers) who "knowingly" violate or attempt to violate the law. In many cases, this may be the maximum penalty that can be imposed on the tax-advising entities and accounting firms that have been marketing SUTA dumping.

It is not clear whether UI tax penalties will apply to the payroll of tax or other firms that are not directly involved in a prohibited SUTA dumping transaction. Even if UI tax penalties do apply to most tax advisors, they will apply only with respect to the tax advisor's own payroll, rather than to the payroll of the SUTA-dumping company. If these UI tax penalties do not apply, the only penalty that attaches to a tax advisor is a maximum $5,000. Given the amount of underpayment of taxes that is represented by SUTA dumping schemes that have thus far been uncovered by states, $5,000 is clearly not sufficient to deter tax advisors to encourage companies to dump their payroll taxes.

Most states have followed the model bill's approach, and five states have even lower penalties. However, some states have recognized the deficiency in Labor's model and opted for greater penalties for tax advisors. The California law, for exam-

ple, provides for penalties of $5,000 or 10 percent of the UI taxes unlawfully underpaid, specifically on tax advisors. North Dakota's recently passed legislation, HB 1195, proposes penalties of up to $25,000.

We believe that the Department of Labor should revise its model bills in recognition that its penalties for tax and financial advisors are far below the levels required to provide "meaningful" penalties for SUTA dumping. At the conclusion of our testimony is a table that compares the civil penalty provisions of state laws and proposals with the Labor Department model, with notes indicating ways in which some state laws differ from the model penalty provisions. While some states have existing penalties or criminal provisions they feel should apply, it is difficult to judge those laws as a group. Certainly, in our view, state laws implementing the SUTA Dumping Prevention Act have not resulted in the sort of meaningful penalties that Congress called for in the Act.

Conclusion: More Honest Tax Enforcement or Legitimate Tax Avoidance?

The passage of the SUTA Dumping Prevention Act represented a strong Congressional statement that SUTA dumping damages state UI financing integrity and must be stopped. The Act forced federal and state administrators to take action and created a strong momentum toward honest tax enforcement.

Despite progress in recognizing how SUTA dumping undermines UI experience rating and shifts UI taxes onto honest employers since the Act's passage, an accepting attitude about SUTA dumping among some state legislators, administrators, and a significant number of business groups persists. This attitude views SUTA dumping as an acceptable business practice, and perceives SUTA dumping as legitimately lowering state UI payroll taxes. The persistence of this attitude has meant that most states have not adopted known measures that would more effectively eliminate the practice of SUTA dumping. Instead, the majority of states have taken a hesitant approach toward state SUTA dumping laws.

Mr. Chairman, we thank this Subcommittee for the opportunity to offer our testimony on implementation of the SUTA Dumping Prevention Act of 2004. We would be pleased to answer any questions.

State SUTA Dumping Penalties—Proposed and Enacted Legislation

(Updated June 9, 2005)

State Law and Status	Penalties on Employers			Penalties on Non-employers		
	Labor Model	Higher penalties	Lower penalties	Labor Model	Higher penalties	Lower penalties
Alabama HB 148	X				X	
Arizona HB 2093 (passed)	X			X		
California AB 664 (passed)			X		X	
Colorado HB 1092 (passed)		X		X		
Hawaii HB 708	X			X		
Idaho HB 2 (passed)			X	X		
Indiana SB 612 (passed)	X			X		
Kansas SB 108 (passed)	X			X		
Kentucky SB 113 (passed)	X				X	
Michigan HB 4414, 4415 and SB 171 and 174 (passed)			X	X		
Minnesota HB 898 (passed)			X		X	

State SUTA Dumping Penalties—Proposed and Enacted Legislation—Continued

(Updated June 9, 2005)

State Law and Status	Penalties on Employers			Penalties on Non-employers		
	Labor Model	Higher penalties	Lower penalties	Labor Model	Higher penalties	Lower penalties
Mississippi SB 2472 (passed)	X			X		
Missouri HB 500 (passed)	X			X		
Montana HB 159 (passed)			X	X		
Nebraska LB 484 (passed)	X			X		
N Hampshire HB 170 (passed)	X			X		
N Jersey A2941			X			X
N Mexico HB 520 (passed)	X					X
N Dakota HB 1195 (passed)	X				X	
Ohio SB 81 (passed)	X			X		
Oklahoma SB 763 (passed)			X	X		
Pennsylvania SB 464 (passed)						
S Dakota SB 13 (passed)	X			X		
Utah HB 10 (passed)			X	X		
Vermont H 0071 (passed)	X			X		
Virginia H 2137 (passed)			X	X		
Washington HB 2246			X			X
Wyoming SB 80 (passed)	X				X	
Total		**1**	**8**	**18**	**6**	**2**

Chart notes: States proposing higher penalties than Labor Department model for employers who violate law: CO (maximum tax rate plus 2.7%); **States proposing lower penalties than Labor Department model for employers who violate law:** CA (max tax rate plus 2% but only for 3 years); ID (10% taxable wages for 1 year); NJ (max rate for 5 quarters); MI (no additional penalties in proposal); MN ($5,000 or 2% of payroll for 1 quarter for notification violation); MT (6% taxable wages for 1 year, a maximum of $1,218); OK (10% taxes due for 4 quarters); UT (max rate for 2 years); VA (max rate for 2 years) WA (max rate plus 2% for 1 year, plus costs of audit).

States proposing higher penalties than Labor Department model for non-employer tax advisors who violate law: AL ($10,000 or 10% of taxes underpaid); CA ($5,000 or 10% of taxes underpaid, specifically applies to tax advisors); KY ($5,000 plus higher tax rate for "persons," whether or not they are "employing units"); MN ($5,000 or 2% of quarterly payroll for notification violation); ND ($25,000); WY ($50,000). **States proposing lower penalties than Labor Department model for non-employers who violate law:** MI (no additional penalties in proposal, but existing penalties exceed minimum requirements of Act); NJ (no additional penalties); NM ($3,000 maximum); WA (no new penalties).

Notes: Several states provide for criminal penalties for firms and tax advisers. We focus on the civil penalty provisions because it is generally more efficient for state agencies to impose civil penalties than to pursue criminal remedies.

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Chairman HERGER. Thank you, Mr. McHugh, and I think the point you have made is very well taken. It is always that rarity, that handful who are taking advantage of the system. The vast majority are good, honest, law-abiding citizens who are trying to do what is right. Our goal here on This Committee is to go after those who are purposely misusing the system and costing everybody money and hurting the system. Mr. Temple to testify.

STATEMENT OF LARRY TEMPLE, EXECUTIVE DIRECTOR, TEXAS WORKFORCE COMMISSION, AUSTIN, TEXAS

Mr. TEMPLE. Chairman Herger, Ranking Member McDermott, and distinguished members of the Subcommittee, thank you for allowing me to testify this morning. My name is Larry Temple. I have the pleasure of serving as Executive Director of the Texas Workforce Commission, which is charged with the administration of the State's unemployment insurance program.

Mr. Chairman, it is my belief that States must always strive to operate an unemployment system that has the confidence of both the claimants who receive the benefits and the employers who pay the taxes. Our experience in Texas has shown that the vast majority of our employers, over 400,000 of them, are satisfied with the scope and intent of our unemployment insurance program.

State Unemployment Tax Act dumping has been a significant problem in Texas, as unscrupulous employers have gained an unfair advantage over their competitors by unloading their payroll tax obligations onto their competitors. Those employers who follow the spirit of the law find themselves subsidizing those who abuse the system. For example, we estimate that one prominent national retailer paid an extra $550,000 in payroll taxes in the first quarter of 2004 alone simply because they followed the spirit of the law and did not resort to SUTA dumping. The Workforce Commission's top recommendation to the Texas Legislature in the 2005 regular ses-

sion was the passage of legislation to stop SUTA dumping. I am happy to report that the legislature responded, and the anti-SUTA dumping bill awaits Governor Rick Perry's signature later this week, and it will go into effect on the 1st of September of this year.

The bill, H.B. 3250, was filed by House Economic Development Chairman Allan Ritter, a Democrat, and sponsored in the Senate by Senate Business and Commerce Chairman Troy Fraser, a Republican. Both the AFL–CIO and the National Association of Professional Employee Organizations testified in favor of the bill. H.B. 3250 passed in both the House and Senate Committees with unanimous support, and it was approved in both chambers by unanimous consent. We believe that this bill, once implemented, will result in savings of over $78.5 million per year to the Texas's unemployment trust fund.

I would like to draw attention to an aspect of the issue that tends to go generally unnoticed. When an employer engages in SUTA dumping, there is really no incentive for them to respond to our request for information regarding separation issues. The impact is that we are likely paying benefits to some individuals who would not be eligible for those benefits if we had been informed of the reason for their separation. Under our new SUTA dumping law, employers face the potential risk of financial penalties when they fail to comply with our information requests. In effect, if they do not provide us with this information, they will be penalized through tax rate increases. It is our strong belief that implementation of such a policy will improve our employer cooperation, reduce the amount of improper benefits paid out, and further lower the tax rates that we have to charge our employers.

While the passage of proactive, reform-minded legislation is a necessary first step in arresting abuse of the system, true success can only be achieved when they are coupled with a vigorous enforcement mechanism. Since accepting the position of Executive Director about 2 years ago, I worked to reorganize the commission's resources to put all the anti-fraud mechanisms in place, and I created the Office of Program Integrity, which was charged with consolidating all of our investigations, statistical sampling, fraud detection, performance analysis, sub-recipient monitoring, the BAM unit, which was buried down in the bowels of the agency somewhere—a lot of people did not know it even existed at the time—with the whole goal of improving the sharing and cooperation. I am happy to say that it has produced immediate results.

We have reduced our overpayment rate by one-fifth. They are now charged with developing a similar plan for underpayments, and we are much more capable now of pinpointing our overpayments. The Federal goal for States to find overpayments is 59 percent. In Texas we are now detecting 89 percent. On January 1st of this year, we established a new regulatory enforcement division that consolidated all of our collection and prosecution initiatives through improved coordination with our local prosecutors and the Attorney General's Office. In 2003, we referred 178 fraud cases for prosecution. That number increased to 223 last year. To date, the division has 200 cases in the pipeline for referral, and our benefit payment control staff have identified an additional 729 that are eligible for fraud prosecutions.

Last year, we collected $21.3 million in delinquent taxes owed by employers through tax liens, $20.3 million in delinquent taxes through bank freezes and levies, and $384,000 in delinquent taxes through bankruptcy proceedings, which includes getting stock from a national pizza franchise that is now worth about $45,000 for the tax. So we held onto it long enough that it was worth something we could sell and get the money back. So we will endure.

Through the end of May, our Regulatory Division is ahead of last year, and like North Carolina, which I want to thank for taking the lead in the pilot, the software has been a success, I am pleased to report. Our goal in Texas is to have a system where the employers and the claimants both understand that if an unemployed individual truly needs help, we are there to provide it. Our citizens and our Workforce Commission will not tolerate the abuse. Thank you for inviting me to share the Texas perspective with you. I have submitted my full testimony for the record and will be happy to answer any questions.

[The prepared statement of Mr. Temple follows:]

Statement of Larry Temple, Executive Director of the Texas Workforce Commission, Austin, Texas

Chairman Herger, Ranking Member McDermott, and distinguished members of the Subcommittee, thank you for allowing me the opportunity to testify this morning. My name is Larry Temple. I have the pleasure of serving as Executive Director of the Texas Workforce Commission. TWC is charged with the administration of Texas' Unemployment Insurance program.

Mr. Chairman, it is my firm belief that states must always strive to operate an unemployment system that has the confidence both of the claimants who receive the benefits and the employers who pay them. Our experience in Texas has shown that the vast majority of Texas employers are satisfied with the scope and intent of our Unemployment Insurance program.

SUTA dumping has been a significant problem in Texas, as unscrupulous employers have gained an unfair advantage by loading their payroll tax obligations onto their competitors. Those employers who follow the spirit of the law find themselves subsidizing those employers who abuse the system. For example, we estimate one prominent national retailer paid an extra $550,000 in payroll taxes in the first quarter of 2004 simply because it followed the spirit of the law rather than resort to SUTA dumping.

The Texas Workforce Commission's top recommendation to the Texas Legislature in the 2005 regular session was the passage of legislation to stop SUTA dumping. I am happy to report that our Legislature responded, the anti-SUTA dumping bill awaits Gov. Rick Perry's signature later this week, and it will go into effect on the 1st of September.

The bill, HB 3250, was filed by House Economic Development Chairman Allan Ritter, a Democrat; and sponsored in the Senate by Senate Business & Commerce Chairman Troy Fraser, a Republican. Both the AFL–CIO and the National Association of Professional Employee Organizations testified in favor of the bill, HB 3250 passed both the House and Senate committees with unanimous support, and it was approved in both chambers by unanimous consent.

We estimate that over the next five years, the implementation of HB 3250 will result in savings of $78.5 million per year to Texas' Unemployment Insurance trust fund. This will visibly reduce the replenishment aspect (taxes based on Statewide benefits and taxed wages) of the overall unemployment tax rate, which makes up the bulk of what most Texas businesses pay.

Furthermore, I'd like to draw attention to an aspect of this issue that tends to go generally unnoticed. When an employer engages in SUTA dumping, it doesn't respond to separation requests on its former employees. There is no incentive for employers to respond because the employer is simply going to change their identity. The impact is that states are likely paying benefits to some individuals whom would not be eligible for them if their previous employers had informed of the reason for their separation. Under the new SUTA dumping law, employers face the potential risk of financial penalties when they fail to comply with our information requests. In effect, when employers don't provide us with this information, they will be penal-

ized through tax rate increases. It is our strong belief that implementation of such a policy will improve employer cooperation, reduce the amount of improper benefits paid out, and further lower the tax rates we must charge employers.

While the passage of proactive, reform minded legislation is a necessary first step in arresting the flagrant abuses of this system, true success can only be achieved when such laws are coupled with vigorous enforcement mechanisms. Since accepting the position of Executive Director almost two years ago, I worked to reorganize our Commission's resources to put those anti-fraud mechanisms into place. One of my first acts as Executive Director was creating an Office of Program Integrity. This office was charged with consolidating our Investigations, Statistical Sampling, Fraud Detection, Performance Analysis, and Sub-recipient Monitoring with the intent of improving information sharing, cooperation, and employee morale and has produced instant results.

These changes have not only reduced our overpayment rate by one-fifth, but have allowed for noticeably more accurate predictions of our overpayments. Furthermore, TWC is now much more capable of pinpointing those overpayments. The federal goal is for states to find 59% of their predicted overpayments. In Texas, we find 89%.

On January 1st of this year, TWC established a new Regulatory Enforcement Division that consolidated all of our collection and prosecution efforts into one unit. Even though this was done within existing resources, the new structure has increased our effectiveness through improved coordination with both local prosecutors and the Texas Attorney General's Office. This new division will also help us better identify repeat criminal offenders and emerging trends in criminal conduct.

In 2003, the Texas Workforce Commission referred 178 fraud cases for prosecution. That number increased to 223 last year. To date, our Regulatory Enforcement Division has 200 cases in the pipeline for referral and our Benefit Payment Control staff have identified 739 additional cases that are eligible for fraud prosecutions.

Prosecutors obtained 39 convictions in 2003, 74 in 2004, and so far pursued 48 for 2005. As a result of those prosecutions, the Texas Workforce Commission recovered more than $1.5 million in fraudulent payments in 2003, nearly $1.38 million in 2004, and $515,000 through the first five months of 2005. As the 2005 numbers show, the word has gotten out that TWC is aggressively pursuing unemployment fraud, and as a result curtailed, fraudulent activity leading to a reduction in recovered payments.

Last year, TWC collected $21.3 million in delinquent taxes owed by employers through tax liens, $20.3 million in delinquent taxes through bank freezes and levies, and $384,000 in delinquent taxes through bankruptcy proceedings. Through the end of May, our Regulatory Enforcement Division's tax lien collections were running 10% ahead of last year, and we are now collecting 99% of the amount covered by the lien. Our Regulatory Enforcement Division's bank freeze collections were also up almost 7%.

Lastly, like North Carolina, Texas was a pilot state for the SUTA Dumping Detection System software. I am pleased to report that it is working well and we can see that it will be a powerful tool for us to identify and crack down on companies who are trying to shirk their responsibilities.

In Texas, it is our goal to have an unemployment system where employers and claimants both understand that if an unemployed individual truly needs help, we are here to provide it. However, our citizens and this Commission will not tolerate any abuse of the system.

Thank you for inviting me to share the Texas perspective with you today. I have submitted my full testimony for the record, and will be more than happy to answer your questions.

ATTACHMENTS:

1. HB3250—Texas' SUTA Dumping legislation

H.B. No. 3250

AN ACT

relating to the acquisition of unemployment compensation experience after the transfer of an employing unit; providing penalties.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

SECTION 1. Section 201.022, Labor Code, is amended to read as follows:

Sec. 201. 022. EFFECT OF BUSINESS ACQUISITION. In this subtitle, "employer" also means an individual or employing unit that acquires or otherwise receives, through any means, all or part of the organization, trade, [~~or~~] business, or workforce [~~of another, or substantially all of the assets thereof~~,] of another that was an employer subject to this subtitle at the time of the acquisition.

SECTION 2. Section 204.081, Labor Code, is amended to read as follows:

Sec. 204.081. DEFINITIONS [~~DEFINITION~~] . In this subchapter;

(1) "Compensation [~~,"compensation~~] experience" includes the period that benefit wage credits or benefits have been chargeable and any other factor under Subchapter A, B, C, or D necessary to the computation of experience rating under those subchapters.

(2) "Person" means an individual, trust, estate, partnership, association, company, or corporation.

(3) "Substantially common management or control" exists if, after the acquisition of the organization, trade, or business of an employing unit, the predecessor employing unit continues to:

(A) own or manage the organization that conducts the organization, trade, or business;

(B) own or manage the assets necessary to conduct the organization, trade, or business;

(C) control through security or lease arrangements the assets necessary to conduct the organization, trade, or business; or

(D) direct the internal affairs or conduct of the organization, trade, or business.

(4) "Substantially common ownership" exists if, on the date of an acquisition of the organization, trade, or business of an employing unit, a shareholder, officer, or other owner of a legal or equitable interest in the predecessor employing unit, or the spouse or a person within the first degree of consanguinity or affinity, as determined under Chapter 573, Government Code, of the shareholder, officer, or other owner;

(A) is a shareholder, officer, or other owner of a legal or equitable interest in the successor employing unit; or

(B) holds an option to purchase a legal or equitable interest in the successor employing unit.

(5) "Transfer of trade or business" includes the transfer of part or all of an employer I s workforce to another employer if, as the result of the transfer, the transferring employer no longer performs trade or business with respect to the transferred workforce and the employer to whom the workforce is transferred performs trade or business with respect to the workforce.

(6) "Knowingly" means having actual knowledge of or acting with deliberate ignorance of or reckless disregard for the prohibition involved.

SECTION 3. Section 204.083, Labor Code, is amended to read as follows:

Sec. 204.083. ACQUISITION OF ALL OR PART OF EXPERIENCE-RATED ORGANIZATION, TRADE, OR BUSINESS; TRANSFER OF COMPENSATION EXPERIENCE. The transfer of the predecessor employer's compensation experience to the successor employer is required if the predecessor employing unit transfers, through any means, all or part of the organization, trade, or business, to the successor employer and there is substantially common management or control or substantially common ownership of the entities. [~~An employing unit that acquires all of the organization, trade, or business of an employer and that continues operation of the organization, trade, or business acquires the compensation experience of the predecessor employer if on the date of the acquisition, a shareholder officer, or other owner of a legal or equitable interest in the predecessor employer, or the spouse or a person within the first degree of consanguinity or affinity, as determined under Chapter 573, Government Code, of the shareholder, officer, or other owner:~~

[~~(1) is a shareholder, officer, or other owner of a legal or equitable interest in the successor employing unit; or~~

[~~(2) holds an option to purchase a legal or equitable interest in the successor employing unit.~~]

SECTION 4. The heading to Section 204.084, Labor Code, is amended to read as follows:

Sec. 204.084. ACQUISITION OF PART OF EXPERIENCE-RATED ORGANIZATION, TRADE, OR BUSINESS: APPROVAL OF TRANSFER OF COMPENSATION EXPERIENCE WITHOUT SUBSTANTIALLY COMMON MANAGEMENT OR CONTROL OR SUBSTANTIALLY COMMON OWNERSHIP; CONTRIBUTION RATE.

SECTION 5. Section 204.084, Labor Code, is amended by amending Subsections (a) and (d) and adding Subsections (e) and (f) to read as follows:

(a) If an employing unit acquires or otherwise receives, through any means, [a] part of the organization, trade, or business of an employer, and transfer of compensation experience is not required by Section 204.083, the successor employing unit and the predecessor employer may jointly make a written application to the commission to transfer the compensation experience of the predecessor employer that is attributable to the part of the organization, trade, or business acquired to the successor employing unit.

(d) The commission shall [~~may~~] deny a transfer of compensation experience under this section if the commission determines [~~based on credible evidence~~] that the transfer [~~acquisition~~] was done primarily to qualify for a reduced compensation experience rating [~~unemployment insurance tax rate~~] by either:

(1) circumventing the experience rating system;

(2) or manipulating the experience rating system by minimizing the impact of charge backs to the predecessor's or successor's [~~predecessor employer's~~] tax account.

(e) A successor employing unit that acquires compensation experience under this section and that is an experience-rated employer on the date of and during the period preceding the acquisition shall pay contributions from the date of the acquisition until the end of the calendar year in which the acquisition occurred at the rate applicable to the successor employing unit on the date of acquisition.

(f) A successor employing unit that acquires compensation experience under this section and that is not an experience-rated employer on the date of the acquisition shall pay contributions from the date of the acquisition until the next contribution rate computation date at the highest rate applicable at the time of the acquisition to any predecessor employing unit that is a party to the acquisition. If the commission determines that the transfer was accomplished solely or primarily for the purpose of obtaining a lower contribution rate, the successor employing unit's contribution rate must be determined under Section 204.006.

SECTION 6. Section 204.085, Labor Code, is amended to read as follows:

Sec. 204.085. CONTRIBUTION RATE FOR SUCCESSOR EMPLOYERS WHEN SUBSTANTIALLY COMMON MANAGEMENT OR CONTROL OR SUBSTANTIALLY COMMON OWNERSHIP EXISTS; CERTAIN PARTIAL ACQUISITIONS [~~EMPLOYER~~]. (a) Except as provided by Subsection (d), in the case of a partial acquisition for which the transfer of compensation experience is required under Section 204.083, if the commission determines that the part of the organization, trade, or business tr ansferred is definitely identifiable and segregable and that compensation experience can be specifically attributed to that part of the organization, trade, or business, the contribution rate of the successor must be computed:

(1) based on the successor employing unit's experience for the part of the organization, trade, or business that was not acquired by the transfer; and

(2) as provided by this section for the part of the organization, trade, or business acquired through the transfer.

(b) A successor employing unit that acquires compensation experience under [~~is subject to~~] Section 204.083 [~~or 204.084~~] and is an experience-rated employer on the date of the acquisition shall pay contributions from the date of the acquisition until the end of the calendar year in which the acquisition occurred at a [~~the~~] rate computed by using the compensation experience transferred from the predecessor employer and that of the [~~applicable to the~~] successor employing unit [~~on the date of acquisition~~].

(c) [~~(b)~~] A successor employing unit that acquires compensation experience under [~~is subject to~~] Section 204.083 [~~or 204,084~~] and is not an experience-rated employer on the date of the acquisition shall pay contributions from the date of the acquisition until the end of the calendar year [~~next tax rate computation date~~] at the highest rate applicable at the time of the acquisition to any predecessor employer who is a party to the acquisition.

(d) If the commission determines that the transfer was accomplished solely or primarily for the purpose of obtaining a lower contribution rate, the successor's contribution rate must be determined under Section 204.006.

SECTION 7. Subchapter E, Chapter 204, Labor Code, is amended by adding Sections 204.0851,204.087,204.088, and 204.089 to read as follows:

Sec. 204.0851. CONTRIBUTION RATE FOR SUCCESSOR EMPLOYERS WHEN SUBSTANTIALLY COMMON MANAGEMENT OR CONTROL OR SUBSTANTIALLY COMMON OWNERSHIP EXISTS; OTHER ACQUISITIONS. (a) For a transfer of compensation experience required by Section 204.083 other than a transfer described by Section 204.085(a), the contribution rate shall be computed as provided by this section.

(b) A successor employing unit that acquires compensation experience under Section 204.083 and is an experience-rated employer on the date of the acquisition shall pay contributions from the date of the acquisition until the end of the calendar year in which the acquisition occurred at the rate computed by using the prior 36-month combined compensation experience of the predecessor employing unit and the successor employing unit on the date of the acquisition.

(c) A successor employing unit that acquires compensation experience under Section 204.083 and is not an experience-rated employer on the date of the acquisition shall pay contributions from the date of the acquisition until the end of the calendar year at the highest rate applicable at the time of the acquisition to any predecessor employing unit that is a party to the acquisition.

(d) The contribution rate for experience-rated and nonexperience-rated successor employing units shall, for the years following the year of acquisition, be computed as follows:

(1) for the first year following acquisition, the successor employing unit's compensation experience plus the predecessor employing unit's 24-month compensation experience ending on September 30 preceding the year of acquisition, combined with the predecessor employing unit's compensation experience from that date to the date of the acquisition;

(2) for the second year following acquisition, the successor employing unit's compensation experience plus the predecessor employing unit's 12-month compensation experience ending on September 30 preceding the year of acquisition, combined with the predecessor employing unit's compensation experience from that date to the date of the acquisition;

(3) for the third year following acquisition, compensation experience available to the successor employing unit plus the predecessor employing unit's compensation experience from September 30 preceding the year of acquisition to the date of the acquisition; and

(4) for years subsequent to the acquisition and to the transfer of compensation experience required under Section 204.083, the predecessor employing unit's contribution rate is computed without regard to any transfer of compensation experience required by that section.

Sec. 204.087. OFFENSE; CRIMINAL AND CIVIL PENALTIES. (a) A person commits an offense if the person recklessly, knowingly, or intentionally defeats, evades, or circumvents a provision of this subchapter or if the person recklessly, knowingly, or intentionally attempts, aids and abets an attempt, or advises another to defeat, evade, or circumvent a provision of this subchapter.

(b) An employer who commits an offense under this section may be assessed a civil penalty in an amount equal to two percent of wages as defined in Subchapter F, Chapter 201, for the year during which the violation occurred and for the three years following that year.

(c) A person, other than the employer, who commits an offense under this section may be assessed a civil penalty of not more than $5,000 for a first offense and not more than $5,000 for each subsequent offense.

(d) A civil penalty assessed under Subsection (b) or (c) shall be deposited in the special administration fund established under Section 203.201.

(e) An offense under this section is a Class A misdemeanor. Sec. 204.088. PROCEDURES TO IDENTIFY EXPERIENCE-RATING TRANSFERS. The

commission by rule shall establish procedures to identify the transfer or acquisition of a business for the purposes of this subchapter.

Sec. 204.089. CONFORMITY WITH FEDERAL REGULATIONS. The commission shall administer this subchapter in conformity with any regulations prescribed by the United States Secretary of Labor relating to experience-rating transfers.

SECTION 8. The changes in law made by this Act apply only to an acquisition of an organization, trade, business, or workforce that occurs on or after the effective date of this Act. An acquisition of an organization, trade, business, or workforce that occurs before the effective date of this Act is governed by the law in effect on the date the acquisition occurred, and the former law is continued in effect for that purpose.

SECTION 9. This Act takes effect September 1, 2005.

_____ _____

President of the Senate Speaker of the House

I certify that H. B. No. 3250 was passed by the House on April 18, 2005, by a non-record vote.

_____

Chief Clerk of the House

I certify that H.B. No. 3250 was passed by the Senate on May 25, 2005, by the following vote: Yeas 31, Nays O.

_____

Secretary of the Senate

APPROVED:

_____

Date

_____

Governor

2. TWC press release—fraud prevention

FOR IMMEDIATE RELEASE
DATE: September 13, 2004
MEDIA CONTACT: Larry Jones
PHONE: (512) 463–8556

TWC's Program Integrity Policies Save an Estimated $83 Million

AUSTIN—In an aggressive effort to eliminate all types of Unemployment Insurance (UI) overpayments, the Texas Workforce Commission (TWC) has strengthened policies to ensure the most effective use of tax dollars and that only qualified applicants receive benefits. The new policies already have achieved measurable results, preventing overpayments of an estimated $83 million, a 19 percent decline.

"This proactive approach represents a team effort throughout the agency, and those efforts are to be highly commended," said TWC Executive Director Larry Temple. "We're making significant progress in reducing overpayments, and the numbers support that."

Preventing overpayments is a challenging process. TWC continuously works to increase UI claimants' understanding of the unemployment insurance process and eligibility requirements. By verifying compliance with work search requirements and increasing employer participation, TWC has made significant strides in reducing overpayments. The agency has improved processes and technology to increase accuracy and strengthened collection efforts to cut overpayments as well.

UI benefits distributed to ineligible claimants are the sole cause for overpayments. In some cases, overpayments result from error or fraud. The fraud detection unit investigates questionable claims, represents TWC in appeals and prepares materials for use in prosecutions at the local level.

Workforce boards have increased followup activities after referring claimants to job openings, thus identifying claimants who should no longer be receiving benefits.

Texas is a national leader in UI work search requirements, insisting on a minimum of three work search contacts per week. TWC Call Center Operations staff makes weekly calls to employers to verify a claimant's work search. In addition, TWC administrative staff contacts businesses listed on the work search forms. More than 50,000 work search contacts will be verified through this process by year's end.

New Hire Crossmatch is another initiative used to detect fraud. The names of those new hires are compared with current UI claimants or former claimants with outstanding overpayment balances. New Hire Crossmatch helped the agency avoid or recover nearly $9 million in benefit overpayments in 2003. In a partnership with local law enforcement, TWC also crossmatches its database of UI claimants with Texas county jail populations to determine if any claimants are unavailable to seek work due to incarceration.

In some cases when employers do not respond during the initial determination process, overpayments can result. Claimants begin receiving benefits after an initial determination; however, additional information discovered in an appeal may determine that the claimant does not meet criteria to receive benefits.

When identifying overpayments, the collection unit follows up on active cases with outstanding overpayment balances. The unit pursues recovery through phone calls and collection letters. If a new claim for unemployment is filed, UI benefits are used to offset the overpayment balance.

"By strengthening these policies, TWC is making tremendous inroads in the effort to direct benefits to qualified claimants and focus our efforts on helping people get back to work," said Program Integrity Division Director Fran Carr.

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The Texas Workforce Commission is a state agency dedicated to helping Texas employers, workers and communities prosper economically. For details on TWC and the services it offers in unison with its network of local workforce development boards, call (512) 463–8556 or visit www.texasworkforce.org.

Chairman HERGER. Thank you, Mr. Temple. Now we will turn to questions. The gentleman from Louisiana, Mr. McCrery, to question.

Mr. MCCRERY. Thank you, Mr. Chairman. Mr. Temple, did the Texas law go further than, say, the Michigan law in closing some

of these loopholes that are not required to be closed by Federal law?

Mr. TEMPLE. It did get unanimous support.

Mr. MCCRERY. Which leads me to believe that maybe you left a few loopholes.

Mr. TEMPLE. We did propose some penalties that were higher than the minimum standard, and they were negotiated down through the process. We did go beyond. We have penalties for employers who do not respond to us. Unlike North Carolina, ours is not a felony. It is a Class A misdemeanor. There are substantial fines for the employer and individuals who are not the employer but who assist in some of these SUTA dumping schemes. So we think we did go beyond.

Mr. MCCRERY. Mr. McHugh, explain to me a little bit more about these PEO's. Is that kind of like a temporary services business where they have employees of a certain skill in certain areas and they are ready to send them to your factory to work? Is that what is going on?

Mr. MCHUGH. Well, there are a lot of different arrangements, but the one that I used in my illustration is referred to as "employee leasing," where employees would still work in my factory but they would be on the payroll of another entity, another corporate entity, which would have a different tax rate. Other services might be provided by the PEO in addition to the SUTA dump, so it would not be primarily or solely for the purpose of getting a lower tax rate, so it would not be covered by that section of the Federal law. It truly is an arm's length transaction, so they are not under common custody, control, management, or whatever the other term is.

Mr. MCCRERY. So how would you suggest we close that loophole, if, in fact, it is a loophole?

Mr. MCHUGH. Well, some of the States that have at least proposed to try to adjust it have basically looked at any kind of transaction, getting the power to set aside any kind of transaction that seems—that the underlying purpose seems to be to get the lower tax rate. Other States have looked to—and this was the approach that Michigan tried to take, that even though you are using—I am using a PEO, the PEO would have to report the wages that were being paid to my employees in my workplace under my old account number, and the taxes would be paid on those wages under my old account number. I could still use a PEO if I wanted to use it for payroll services or health insurance administration or other reasons, but I would not be able to use it for the purpose of a SUTA dump under that approach. So that would be at least two approaches that the States have felt that they could use.

Mr. MCCRERY. Mr. Camden, did you have something you wanted to add?

Mr. CAMDEN. No. We are very different services, and he well represented that end. The major problem with the staff leasing firms in this area is that the experience does not transfer when they transfer the employees. So there is a variety of different mechanisms different States could use to require the experience of transfer, and the Michigan example is the one that we were—that you gave was what we were trying to use in that State. There are

different ways you could do it, but when you lose the transfer—and to make it worse than what some staff leasing firms are doing is establishing a new corporate entity for every single new customer that comes in, so they are automatically set at a low level. It adds up to a tremendous amount of dumped experience and a lot of dollars lost to the State.

Mr. MCCRERY. Is there anything that sticks out that would identify these kinds of transactions as being clearly for the purpose of SUTA dumping? That seems to me to be a difficult thing in writing legislation. You have to have a certain percentage of your workforce that within a certain period of time has been shifted, or what? Or are there guidelines we can use to clearly identify when that is the purpose?

Mr. CAMDEN. It is hard to decipher intent. So when we have been giving advice, the States have been urging that instead of trying to decipher intent, just require the experience to transfer. Now, if, in fact, the leasing firms or other entities are able to deliver lower unemployment costs, then the rates will adjust down automatically and benefits will be accrued. To grant them the benefits of the lower experience rating without it having been earned strikes me as kind of a backward as a backward approach for States to take. So rather than trying to get into the intent game, we have generally advised States to just require the transfer of the experience.

Mr. MCHUGH. That is the advantage of having the common reporting. It is fine for them to report the wages for the workers that they have that they are leasing, but by associating it with the account of the prior employer, they are not able to do the SUTA dump. They are not considered the employees of the PEO. They are still considered, at least for purposes of unemployment insurance, to be the employees of the client employer.

Mr. MCCRERY. Okay. Thank you, Mr. Chairman.

Chairman HERGER. The gentleman's time has expired. The gentleman from Washington, Mr. McDermott, to inquire.

Mr. MCDERMOTT. Doesn't that defeat the purpose of the PEO? What would be the purpose of a PEO if you stopped the transfer?

Mr. MCHUGH. Well, I think the PEO firms, at least in public, would deny that the primary purpose for their existence is to help their firms avoid workers' comp and UI premiums. They always claim that there are a lot of additional services that they are providing to their client firms.

Mr. MCDERMOTT. Like what?

Mr. MCHUGH. Well, like health insurance administration, fringe benefit administration, payroll services.

Mr MCDERMOTT. So they transfer the same health plan across and pension across? When I take my staff and put them over in this PEO that he is running, do they get the same pension and health care that they had when I had them, or is that a way of cutting that also?

Mr. MCHUGH. That varies. Sometimes they have a health plan that they can use. A lot of small employers can be grouped together and afford to purchase health care that they would not be able to afford if their little 15-person firm was by itself. Sometimes there

are no pensions. Sometimes people do lose their former pension and get a new 401(k). I think it really varies.

Mr. CAMDEN. Congressman, we do both. We have a PEO business, which is fairly small, and a very large staffing business. As we are selling staff leasing or PEO products, we are arguing very much that we have better benefit administration than smaller companies are able to achieve, very much the health care argument that was made here, as well as 401(k) administration, vacation, and holiday. All of that we would tend to argue because it is our expertise we can do that better. Most States who have tried to analyze where their SUTA dumping problems have emerged would tell you that anywhere between 40 to 60 percent, was the testimony that we heard in the Michigan hearings, came from the PEO firms. It is a problem we need to work on in terms of going beyond the legislation that has been done.

Mr. MCDERMOTT. The way to go beyond it, does it require us to pass a law again? Or can DOL change things or States require enforcement? What I am looking at, the same question that Mr. McCrery sort of asked. You present us a problem. Now, how do we fix it? The question is, where do you put the fix—in the Feds or the DOL or tell the States to do it? Or what is the way to do it? Really it is a question for all of you.

Mr. MCHUGH. Well, I would like to know if the Secretary of Labor thinks that she has the authority to issue regulations addressing the PEO issue or not. They seem to have taken a fairly cautious approach to enforcing the Act so far. They have not talked about any regulatory action. Some of the guidance that they have given seems to indicate that they have a limited view of what the regulatory authority is. You did say there are four things the States have to do, and the fourth one is comply with any regulations issued by the Secretary of Labor on this. So it seems like at least potentially the DOL could address the PEOs, or if they can't or won't do it, then Congress would have to address it.

Mr. MCDERMOTT. She works for us, at least titularly.

[Laughter.]

Maybe that is the way to go. Let me hear a little bit more about this whole business about misclassification. Is there any way we can get that thing going? What do we need to do with it in terms of people being classified as contractors?

Mr. MCHUGH. Well, I think one part of it is a resource question. The States do not have sufficient resources to have the auditors they need to go out and reclassify misclassified employees. Part of it is the test that employers—of employment that is used in the States. Mr. Clegg testified that the common law test is adequate. Some States have the ABC test of employment, which is at least considered by NELP to be a superior test. Then part of it is just attitudinal, and there has developed in this country a very accepting attitude of law-breaking in the employment area. Unfortunately, I think at one time employers would hesitate to violate wage and hour laws or not pay people when they were supposed to pay them or try to do some of the things we see them doing with SUTA dumping. I would be curious. Of the people that are lined up for prosecution in Texas, how many of them are employers and how many of them are workers? I would be willing to bet 95 or 99

percent of them are workers, not employers. The last time an employer got nailed for fraud in Michigan before your focus on it was decades ago. So part of it is attitudinal as well.

Mr. MCDERMOTT. Thank you.

Chairman HERGER. The gentleman's time has expired. The gentleman from Michigan, Mr. Camp, to inquire.

Mr. CAMP. Well, thank you, Mr. Chairman. Mr. Bishop, I am interested in your thoughts on Mr. McHugh's comments and Mr. Camden's on the professional employee organizations and that loophole and obviously also the weak penalties. Could you just comment on that?

Mr. BISHOP. Sure. Well, it is true that the initial legislation that was enacted did not address this issue specifically, and we thought it was appropriate in the context of those relationships. As we have heard today, those relationships can be complex. It can be sometimes hard to legislate at the Federal level. So the legislation did not address some of the things that are being spoken of today.

The legislation does require us, by July 15th of 2007, to report to Congress, and, of course, that is 2 years away. In the meantime, we are more than willing to listen to the States, work with the States, and if these kinds of things continue to emerge, continue to have a dialogue with this Subcommittee to inform you and work together to see if further steps need to be taken to close existing loopholes. As was said, people are very smart and savvy, and as soon as we try to legislate something, another thing will come up. So we just have to be really careful that we do things that do not have unintended consequences.

I would like to, if I could for the record, clarify one thing that was mentioned. It was stated by a witness that the President's budget cut $750 million from Employment Services. This is an inaccurate statement. The Administration's budget consolidates three funding streams that are currently duplicative for employment services, and that consolidation was reflected and passed by the House in H.R. 27. So to say that we have cut $750 million of services to workers is not accurate.

Mr. CAMP. Mr. Bishop, I am also interested in Mr. Clegg's comment that the States are really passing laws that are prospective only in this area and that would, therefore, write off millions of dollars in past losses. Can you comment on that as well?

Mr. BISHOP. I do not have in front of me the specific information on how many of the laws that are being passed are prospective versus retrospective. I think what we could do would be to provide the Subcommittee with the information on the legislative proposals that have been passed so you would have that information.

Mr. CAMP. Okay. Mr. Camden, do you have any thoughts on the prospective-only nature of some of the State laws that are passed?

Mr. CAMDEN. I think it is easier for States to go after the prospective because they have got a cleaner legislative fiat to work from. I think what North Carolina has shown is that the common law and passed laws that are in place are a sufficient prosecutorial base, but it takes more work and there are less resources to draw on in order to do that.

Mr. CAMP. All right. Thank you very much. Thank you, Mr. Chairman.

Chairman HERGER. Thank you, Mr. Camp. The gentleman from California, Mr. Becerra, to inquire.

Mr. BECERRA. Thank you, Mr. Chairman. Thank you all for your testimony and for helping us better understand and hopefully come up with some changes that can help us continue with model legislation that DOL can submit to the various States for consideration.

Mr. Camden, a question for you. Can you distinguish—I won't say "easily," but with some work, but can you still make a clear distinction through the law between a staffing agency that is providing, in essence, temporary workers on a legitimate basis versus those that are trying to do this for tax evasion purposes? Is it easy to try to come up with a definition that will clearly leave those who are trying to do this legitimately through staffing versus those who are just trying to evade taxes?

Mr. CAMDEN. I don't know. Again, we have chosen to stay away from the intent issue and just to say make everybody transfer experience and it is the easiest way to bypass the whole intent. So we have not tried to do it on intent. Staff leasing and temporary staffing firms are very different in how they perform and who owns the employment relationship and so on. So that part is easy. To identify those who have an intent to break the law I think is difficult.

Mr. BECERRA. So at some point, a legitimate staffing firm that provides temp employees can break over into the side of conducting or engaging in employment practices that are, for tax purposes, illegal. Is there something—what gives us that sense of when it is that a firm starts to go over the edge?

Mr. CAMDEN. It would be difficult for that to happen to a temporary staffing firm because we own the employment history of our temporary employees, and it is measured in tens of thousands of people by State. So a movement in and out of a few hundred does not particularly matter. Now, what you do see and what we have seen are some temporary staffing firms who seed companies, new companies, in order to get the lowest employment rate, and then they transfer thousands of employees into the seed company. All the detection tools you currently are working at putting in place will catch that and have done so.

Mr. BECERRA. It seems that there is ultimately something that triggers you or some inspector in determining that what is going on is now beyond just a staffing activity between an employer and a staffing or a leasing firm. If there is anything that anyone here can come up with that can help guide us more in terms of providing further definition for DOL and for Congress, we would appreciate it. I suspect you have already seen some of this with some of the States that have tried to come up with legislation, but perhaps have not quite succeeded in getting the legislation passed. Anything that you all think would be helpful for us, the more it is done through regulation, I think the better, because it is tough to try to legislate these parameters well without using an ax and trying to do this. So any help you can provide us would be great.

Another question. Best practices, if you can—I know that we have what is considered model legislation that DOL has sent to the States for consideration. If you can also just give us your one or

two points on what would be now given that the implementation of the legislation that we passed out a year or 2 ago, and tell us now what would be the one or two crucial things to do. I know some of you in your written testimony have mentioned some of these things, and some of you have outlined what some of the States have tried to do. Give us a sense of what you think we can quickly do, the one or two things that should not be that difficult to get through Congress or to see if DOL can do through regulation that we can move toward, because I know that all of you have said that this is an evolving phenomenon here you do one thing and all of a sudden clever folks find a different way to get past this. So the one or two things that you think we can try to move on most quickly, so Mr. Camden could continue coming back saying, "Thanks very much for moving faster than we expected."

Finally, if you all can—because I know my time is expiring and we do have votes. If you can give us any suggestions on trying to deal with this independent contractor issue where we have the misclassification going on, because my understanding is it is fairly substantial, and to allow that to occur is another way of allowing States to be underfunded and allowing legitimate employers—and, Mr. Camden, yours would be one—to have to absorb the costs for unemployment compensation insurance. I do not think that is fair. So anything you have that would help us deal with the phenomenon where employers are misclassifying their employees as independent contractors we would appreciate it. Thank you very much for your testimony.

Chairman HERGER. Thank you, Mr. Becerra. I want to thank each of you for appearing here today and giving us updates and insights. It will be helpful as we consider additional steps to strengthen and improve our unemployment system. If you do not mind, I do have a few questions that I might submit to you in writing. This has been very helpful. Again, I share the thoughts of the gentleman from California in that when we have our next hearing we want to be able to have the same comments that you led off with, Mr. Camden. Again, I want to thank each of you, and with that this hearing stands adjourned.

[Whereupon, at 11:12 a.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Edward A. Lenz, American Staffing Association, Alexandria, Virginia

On behalf of the American Staffing Association, I am writing to express our industry's appreciation for your efforts to protect the financial integrity of the nation's unemployment insurance system. ASA submits the following statement for inclusion in the record of the June 14, 2005 hearing on implementation of the SUTA Dumping Prevention Act.

ASA represents over 1,100 companies that operate approximately 15,000 offices representing about 85 percent of the $63 billion U.S. staffing industry. Our members include the nation's largest publicly owned staffing firms as well as privately owned regional and local staffing firms throughout the country. Such firms have contributed significantly to the well-being of the U.S. economy by providing critical labor market flexibility that benefits both employers and workers.[1]

[1] *See* U.S. Dep't of Labor, "Just-in-time" Inventories and Labor: A Study of Two Industries, 1990–1998, Report on the American Workforce, 5 (1999); Economic Report of the President (February 2000) at p. 89; U.S. Senate Committee on Banking, Housing and Urban Affairs, Hearing on the Nomination of Alan Greenspan (Jan. 26, 2000) S. Hrg. 106–526 at p. 21; see also Green-

In 2004, U.S. staffing firms employed 2.6 million people on any given day. But taking into account the high turnover inherent in temporary work (average employee tenure was just 11 weeks) staffing firms employed almost 12 million employees in total over the course of the year. Temporary employees are assigned to work in a wide range of job categories from traditional industrial and clerical to accounting, engineering, information technology, health care, legal, and other professional occupations.

The distinguishing characteristics of temporary staffing firms are that they recruit, screen, train, and hire individuals with specific skills from the general labor market and then assign them on an as-needed basis to their clients, generally for short periods of time, to support or supplement their workforces, to provide assistance in special work situations such as employee absences, skill shortages, and seasonal workloads, or to perform special assignments or projects. Staffing firms have traditional employer rights and duties with respect to their temporary employees, including payment of wages and payroll taxes, providing workers' compensation insurance, hiring and firing, handling grievances, and reassigning their employees to other clients.

Payroll taxes are a large part of staffing firms' total tax burden—and their SUTA taxes tend to be higher than most other service businesses because of the transitory nature of the temporary workforce. So when other employers don't pay their fair share of those costs, it drives trust fund levels down and SUTA taxes up and staffing firms get hit disproportionately. Fortunately, with your leadership, Congress acted swiftly last year in passing the SUTA Dumping Prevention Act (Act) and significant progress has been made in addressing the abuses. While the Act has made a real difference, much remains to be done to ensure the integrity of the unemployment insurance system.

The Act was not meant to be a panacea. Its primary goals were to highlight the problem, establish minimum guidelines to move states in the right direction, and to give them the flexibility to develop appropriate solutions. Unfortunately, some states have chosen not to go beyond the minimum requirements, leaving significant loopholes. For example, the Act prohibits intra-company transfers to avoid high unemployment claims experience, but does not cover transfers of experience between entities that are not commonly-owned or controlled. In some states, employers can still shed their unfavorable unemployment experience if the transfer wasn't done "solely or primarily" for the purpose of avoiding UI taxes. We believe the experience of a given workforce always should be reflected in the premiums paid, regardless of the organizational structure or business model employers choose to adopt.

Even if such loopholes are closed, strong enforcement by the states is essential. Some states are doing a better job than others and there is much room for improvement. To create an effective multi-state enforcement system, there should be better cooperation between the states on tactics and information sharing. The Department of Labor can help by sharing best detection practices, communicating newly developed dumping techniques as they are identified, and helping to coordinate state enforcement efforts. The Department also should exercise to the fullest extent its statutory authority under the Act to issue regulations aimed at SUTA dumping in whatever forms it may take.

The shared nature of the unemployment compensation system requires each partner to play its full role. Congress has taken a big step by passing the Act and should continue to provide oversight. The Department of Labor also has a vital role as outlined above. But state enforcement is the key. States have strong financial incentives to vigorously enforce the Act and to work cooperatively with other states in doing so. But if the states fail to deal comprehensively and effectively with the problem, Congress should consider taking other steps as may be necessary and appropriate to protect the integrity of the system.

Statement of David Plawecki, Michigan Department of Labor and Economic Growth, Detroit, Michigan

Mr. Chairman and members of the subcommittee, my name is David A. Plawecki, and I am the Deputy Director for the Michigan Department of Labor & Economic Growth with oversight responsibility for the Unemployment Insurance Agency. In this role I served with lead responsibility for implementation of State Unemployment Tax Act (SUTA) Dumping legislation in Michigan. I also currently serve as

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span, *Global Economic Integration: Opportunities and Challenges* (Aug. 25, 2000), Remarks at a Symposium Sponsored by the Federal Reserve Bank of Kansas City at pp. 2–3.

the Chair of the National Unemployment Insurance Committee for the National Association of State Workforce Agencies (NASWA).

My experience includes thirteen years as Deputy Director of the Unemployment Insurance Agency, eight years as Chair of the Michigan Senate Labor Committee, and four years as ranking minority member. The Labor Committee had legislative jurisdiction over all state unemployment insurance law. I was the state legislative sponsor of the law that converted Michigan from a flat rate tax to an experience rated tax for Unemployment Insurance.

Michigan SUTA Experience

Using the experience rated tax system to finance Unemployment Insurance (U.I.) in Michigan maintains broad support amongst both the employer and labor community. Over the past few years, however, there have been concerns that tax revenues were under expectations. We now believe that tax avoidance schemes that have been nationally labeled as "SUTA Dumping" were the likely reason. Because of this we laud the national action taken by Congress to require all states to examine their laws for tax avoidance loopholes, enact SUTA Dumping prevention laws, protect Unemployment Insurance Trust Funds and thus maintain a level playing field among all states.

In Michigan we projected between 62 million and 95 million dollars in tax losses to the U.I. Trust Fund in 2004 due to SUTA Dumping. In the first six months of active investigation for potential SUTA Dumping, the state Unemployment Insurance Agency had 63 cases involving approximately 630 employers under investigation with a potential tax loss of approximately 25 million dollars. Roughly 60% of those employers are Professional Employer Organizations (PEOs).

Federal Legislative Standards Recommendations

In Michigan, we have learned much about SUTA Dumping practices and the policies that would be most effective in addressing this practice since enactment of the federal legislation. Generally speaking, the changes required of the states under federal law and USDOL guidance have effectively covered most of the areas discovered. There appear to be, however, three areas which we would recommend all states be required to address in order to fully close SUTA loopholes.

1. **Increased penalties on tax advisors.** We would recommend tax advisors be subject to a penalty of at least 50% of the improper tax avoidance. Most advisors collect a significant fee for their advice. Employers often cite an expert who told them the tax practice was OK, even though the questionable tax avoidance practice should have raised a red flag among tax advisors and employers. We know that improper accounting advice impacts companies in many areas. It is time to get tough with all involved in tax avoidance schemes. In Michigan, we passed a strong law and were able to provide for penalizing tax advisors.
2. **No escaped benefit charges through switchbacks between reimbursable and contributing for an employer.** Many state laws inadvertently provide a mechanism for reimbursable employers to time decisions on being reimbursable or contributing, and so they escape responsibility for significant amounts of their benefit charges. Our new SUTA Dumping legislation in Michigan corrected a loophole in our statute that allowed for this.
3. **Require PEOs to report and pay taxes based on each individual client's experience.** Individual client reporting will eliminate what appears to be a massive administrative burden associated with determining whether PEOs are avoiding Unemployment Insurance taxes. In contrast, it requires little additional work on the part of PEOs and offers them some advantages. It will also close an inadvertent loophole that allows PEOs in some states to sell employers a one-time tax advantage using Unemployment Insurance trust funds to finance the advantage. In many states, an employer with a high tax rate, for example 8%, could simply transfer its employees to a PEO with a tax rate of, for example 2%, and instantly save 6% on unemployment taxes (which is typically split in some fashion between the two).

A significant issue that has arisen with states involves PEOs attempting to manipulate the terms "sole or primary reason." In Michigan, PEOs are defending UI tax manipulation as a consequence of manipulating payroll to avoid workers compensation premiums and the state business tax. Individual client reporting would resolve this.

Conclusion

We praise the leadership offered by the Chairman and this Subcommittee in requiring states to take action on SUTA Dumping. Since the Unemployment Insur-

ance system is a true insurance system there is no way for fair operation unless all employers are required to pay the premiums (taxes) their experience fairly dictates. With the increasing number of times workers will be required to switch jobs under today's economy, the safety net of Unemployment Insurance benefits is more important than ever. I hope the above information and suggestions are helpful, and I would be pleased to answer any questions you may have.

Statement of National Association of Professional Employer Organizations, Arlington, Virginia

The National Association of Professional Employer Organizations ("NAPEO") submits this statement for the record of the Subcommittee's June 14, 2005 hearing on "Implementation of the SUTA Dumping Prevention Act of 2004." NAPEO supported the enactment of the SUTA Dumping Prevention Act of 2004 (Pub. L. No. 108–295) (the "2004 Act") and submitted supporting statements to this Subcommittee during the consideration of the legislation. NAPEO has long supported broad-based efforts to eliminate any practice that undermines the integrity of the unemployment compensation system. NAPEO strongly believes that SUTA rates should be experience based and equally applied to all. NAPEO has been actively involved with many state unemployment insurance agencies and state legislatures as they developed and passed legislation in compliance with the 2004 Act. We compliment the Subcommittee for its leadership in the development of this important federal legislation. We believe that states have successfully passed conforming legislation to prevent "SUTA dumping" while carefully preserving legitimate corporate restructurings and not penalizing businesses choosing to utilize the services of professional employer organizations ("PEOs").

NAPEO believes that the 2004 Act appropriately prevents employers from engaging in certain practices that are intended to manipulate the unemployment compensation experience rating system. We are concerned, however, that testimony presented to the Subcommittee inappropriately labeled the use of a PEO as a "loophole" in the 2004 Act and erroneously suggested that state unemployment funds are diminished when clients join a PEO. To the contrary, PEOs provide significant benefits for the state unemployment systems. In the short-run, states often receive a windfall when a client joins a PEO. Over the long-run, PEOs have a significant economic incentive to manage unemployment risk, which benefits the states overall.

In most states,[1] PEOs pay unemployment contributions based on their own experience rating. The state often experiences a windfall when a client company joins the PEO because the PEO pays unemployment tax on the first portion of payroll of each employee regardless of how much of the tax has already been paid by the client company. Essentially, when a company enters into an agreement with a PEO, the "clock starts over" on the employees and all previous unemployment taxes paid by the client company go into the general balance of the unemployment compensation trust fund. In addition, upon entering an agreement with the PEO, the liability for the new client company becomes that of the PEO (operating against its rates and reserves) and the funds in the client's account are forfeited to the state.

The state also benefits because PEOs have a significant economic incentive to effectively manage unemployment claims. PEOs do not benefit from a situation in which contributions into the state's unemployment fund are not commensurate with the claims being made, which would only result in law-abiding taxpayers being required to contribute disproportionately to sustain the fund. States have successfully implemented provisions of the 2004 Act to effectively eradicate practices intended to artificially lower future rates. More specifically, PEOs have no incentive to hold out the prospect of a lower SUTA rate to potential clients that have negative unemployment experience. Engaging a client with negative unemployment experience potentially increases the PEO's SUTA rate and its future rate given that the PEO's rate is based upon the actual experience of its worksite employees at all of its clients' worksites.

PEOs can and do help clients manage unemployment risk, but this occurs by implementing professional human resource programs that achieve higher employee retention and, therefore, fewer unemployment claims. These programs include effective employee screening and hiring processes, employee feedback and appraisal systems, and proper separation procedures. If there is an unemployment claim, a PEO provides value by reducing the length of unemployment by placing employees with

[1] Thirty-six states recognize a PEO as the employer for unemployment insurance purposes and assign the PEO its own experience rating based on the experience of the PEO.

other clients and offering career counseling and job placement assistance to help workers find new positions. PEOs also are better able to scrutinize claims and participate in the administrative process to avoid the granting of inappropriate benefits.

PEOs offer operational efficiencies that state and federal governments may not find possible to achieve when jurisdictions must collect unemployment taxes from a myriad of small businesses. Because the PEO's compensation is tied to payroll, PEOs are meticulous about assuring that payroll for all worksite employees is accurate, complete and properly reported. Additionally, many states require employers with a minimum number of employees to file unemployment taxes electronically. The aggregation of many small and medium size business clients under a single PEO arrangement that files a single report brings efficiencies and administrative savings to the system as well.

In sum, NAPEO continues to support the implementation of the 2004 Act standards, but we strongly oppose any efforts to penalize clients that utilize a PEO. PEOs want a level playing field like all other employers, which means that the rate of tax should be commensurate with the unemployment risk. That policy protects the state fund and it appropriately incents PEOs and all other employers to work to manage unemployment risk.