

HOUSE BILL REPORT

HB 2388

As Reported by House Committee On:
Commerce & Labor

Title: An act relating to ensuring employers do not evade their contribution rate.

Brief Description: Ensuring employers do not evade their contribution rate.

Sponsors: Representatives Conway and Chase; by request of Employment Security Department.

Brief History:

Committee Activity:

Commerce & Labor: 1/12/06, 2/2/06 [DPS].

Brief Summary of Substitute Bill

- Modifies the requirements for determining successor employer unemployment contribution rates when a purpose of the transfer was to obtain a reduced rate by basing the rate on the higher of the involved employers' rates or, if the successor employer was not an employer at the time of the transfer, prohibiting transfer of experience from the predecessor employer and assigning the new employer rate.
- Increases the penalties applicable to employers and other persons who intend to knowingly evade the successorship provisions.
- Applies beginning on January 1, 2006.

HOUSE COMMITTEE ON COMMERCE & LABOR

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 9 members: Representatives Conway, Chair; Wood, Vice Chair; Condotta, Ranking Minority Member; Chandler, Assistant Ranking Minority Member; Crouse, Holmquist, Hudgins, Kenney and McCoy.

Staff: Chris Cordes (786-7103).

Background:

Federal Requirements for States' Unemployment Insurance Laws

General Requirements. The unemployment insurance system is a federal/state program under which employers pay contributions to fund unemployment compensation for unemployed workers. These payments are made under state unemployment tax acts (SUTA) and the

Federal Unemployment Tax Act (FUTA). The FUTA allows the states' employers to receive a tax credit against their federal unemployment tax, and the state receives a share of the FUTA revenues for administration of its unemployment insurance system, but only if the state maintains an unemployment insurance system in conformity with federal law. Washington's program is administered by the Employment Security Department (ESD).

SUTA Dumping Act. In August 2004, the federal "SUTA Dumping Prevention Act of 2004" (SUTA Dumping Act) was enacted. According to the United States Department of Labor, this law is intended to: (1) address a concern that some employers and financial advisors were finding ways to manipulate state experience rating systems so that these employers could pay lower SUTA taxes than their unemployment experience would otherwise allow; and (2) prohibit the following two methods of SUTA dumping:

- An employer escapes high experience rates by setting up a shell company with a lower tax rate and then transferring some or all of its workforce to the shell company.
- An entity starting a business purchases an existing business with a tax rate that is lower than the new business tax rate. Typically, the new business ceases the business activity of the transferred business.

Under the SUTA Dumping Act, the states' unemployment insurance laws must be certified as in conformity with the SUTA dumping requirements by a certain date. For Washington, this requirement will apply beginning with the 2006 tax rate year. Among other things, the federal SUTA Dumping Act requires the states' unemployment insurance laws to adopt certain successor employer provisions, including:

- requiring mandatory transfer of experience when there is substantial common ownership, management, or control of two employers, and one of these employers transfers all or part of its business to the other;
- prohibiting transfers of experience, and instead assigning a new employer rate, when a person who is not an employer acquires an existing employer, and the acquisition was solely or primarily for the purpose of obtaining a lower contribution rate;
- adopting meaningful civil and criminal penalties for persons who knowingly violate or attempt to violate these requirements; and
- establishing procedures for identifying SUTA dumping.

Washington Unemployment Insurance Contribution Rates

General Requirements. Most employment in the state is covered for unemployment insurance. Each covered employer is required to pay contributions on a percentage of his or her taxable payroll, except for certain employers who reimburse the ESD for benefits the agency pays to these employers' former workers. For most covered taxable employers, unemployment insurance contribution rates are determined by the combined rate assigned to the employer based on layoff experience, social costs, and solvency surcharge, if any. The highest contribution rate varies but may not exceed 6.5 percent plus a solvency surcharge, if any.

Requirements for Unqualified Employers. Some covered taxable employers are not qualified to be assigned a combined rate. These unqualified employers include employers who are new

employers and certain successor employers who were not employers at the time of acquiring a business. Until a new employer becomes a qualified employer, the rate is the average industry rate, plus 15 percent of that amount, with a 1 percent minimum rate. For a successor employer who was not an employer at the time of the business transfer, the rate is the rate assigned to the predecessor employer for that rate year, with combined experience determining the rate thereafter, or the new employer rate in that industry until the employer qualifies for its own rate.

Legislation adopted in 2003 changed the rate determination for certain successor employers engaging in a business transfer on or after January 1, 2005. If a new successor employer has substantial continuity of ownership or management of the predecessor's business, the successor is not permitted to use the new employer rate. Instead, these employers must pay at the rate assigned to the predecessor employer, and will have the experience of the predecessor employer transferred to the successor as part of its rate beginning in January following the transfer.

Penalties

Unemployment insurance tax penalties were revised in 2003 to add a penalty for an employer that is delinquent in paying unemployment taxes because of an intent to evade the successorship requirements and for any business that promotes such evasion. This penalty was modified in 2004 to require assigning these employers, or other persons violating this requirement, the highest contribution rate, plus 2 percent, for that calendar year in which the Commissioner of ESD (Commissioner) makes the penalty determination.

It is a gross misdemeanor, with a fine of up to \$5,000 and/or up to one year in prison, if a person who is required to collect and pay unemployment contributions willfully fails to pay the contributions or willfully attempts to evade payment.

Summary of Substitute Bill:

Successor Employers

Generally, a successor employer's contribution rate beginning on January 1 following the transfer of a business is based on a combination of the successor's and the predecessor's relevant layoff experience. However, for transfers on or after January 1, 2005, if the successor employer is not an employer at the time of the business transfer and only a part of the business was transferred, the experience will be assigned to the successor only if this makes the successor employer a qualified employer. If the successor is not qualified, then the new employer rate will apply until the successor qualifies for a different rate, including the transferred experience.

The prohibition that a new successor employer may not use the new employer rate when there is substantial continuity of ownership or management of the predecessor's business is extended to cover situations in which there is substantial continuity of control.

If a significant purpose of a business transfer was to obtain a reduced rate, then:

- if the successor was an employer at the time of transfer, the experience rating accounts of the employers involved are combined into a single account, and the employers are assigned the higher of the predecessor or successor rate effective as of the transfer date; or
- if the successor was not an employer at the time of the transfer, the experience attributable to the predecessor employer must not be transferred and, instead, the new employer rate is assigned.

"Transfer of a business" includes the transfer or acquisition of substantially all or a portion of the operating assets, which may include the employer's work force.

References to determining the applicable new employer rate are changed from the Standard Industrial Classification Code to the North American Industry Classification System.

Penalties

A civil penalty assessment rate is assigned to an employer whose delinquent assessment is due at least in part to an intent to knowingly evade the successorship provisions or to a business found to be knowingly promoting evasion of the successorship provisions. The Commissioner must assign a total rate, which is the sum of the recalculated array calculation factor rate that should have applied and a civil assessment penalty that when added to the recalculated array calculation factor rate increases the total rate to the maximum array calculation factor rate plus two percent. The civil penalty assessment rate is not limited by any statutory maximum rate and is assigned for that rate year and the three following rate years. In addition, the employer must pay the ESD's reasonable audit and collection expenses and may be prosecuted for a gross misdemeanor.

A person who is not an employer and who is knowingly evading or knowingly attempting to evade the successorship provisions, or knowingly promoting the evasion, is subject to a civil penalty of \$5,000 and to the gross misdemeanor penalty as if the person were an employer. The person is also required to pay the ESD's reasonable audit and collection expenses.

"Knowingly" is defined to mean having actual knowledge of or acting with deliberate ignorance or reckless disregard for the prohibition involved, including intent to evade, misrepresentation, or willful nondisclosure.

Penalties and interest collected for evasion of the successorship provisions are to be expended solely for prevention, detection, and collection activities related to evasion of the successorship provisions.

The Commissioner must establish procedures to enforce, and may adopt such other rules as are necessary to implement the successorship provisions.

Application

These provisions are stated to be remedial and apply retroactively to January 1, 2006.

Substitute Bill Compared to Original Bill:

The substitute bill: (1) requires finding that "a significant purpose," rather than "a purpose," of a business transfer was to obtain a reduced rate before the new requirements apply that are related to transfer of experience; (2) clarifies the calculation of the civil penalty assessment rate (which applies to "knowing" evasions of the successorship provisions) by specifying the calculations, referring to the sum of the two calculations as the total rate, and adding that the total rate is not subject to any maximum array calculation factor rate; (3) clarifies the definition of "transfer of a business" by adding that it includes an acquisition of substantially all or a portion of the operating assets, which may include the work force, and deletes the amendments to the definition of "wages" for contribution purposes; (4) replaces the term "new employer rate" with the appropriate statutory reference; and (5) makes other technical changes to make terms consistent.

Appropriation: None.

Fiscal Note: Available.

Effective Date of Substitute Bill: The bill contains an emergency clause and takes effect immediately.

Testimony For: This bill is necessary to conform Washington's unemployment insurance law to federal requirements regarding "SUTA dumping." Washington has been a national leader on SUTA dumping prevention, but is one of nine states that have not yet passed conforming legislation. If not adopted, employers stand to lose about \$1 billion in federal tax credits and the Department could lose its \$88 million administration grant. The bill addresses the state's effort to crackdown on evasion of unemployment taxes. If employers do not pay their fair share, the burden is shifted to other employers. A Government Accountability Office report estimates \$1 billion in illegally avoided taxes, and states report large losses, too. Common tax manipulation schemes, such as shell or sham corporations, are prevented by the bill. These frequently involve the same employer using the same workers, with no change in business. There is a need for both civil and criminal penalties for violations or for advising businesses on these schemes. Better procedures for detecting SUTA dumping are required. The Department will need additional personnel to implement the procedures. The federal law is a minimum requirement that state laws can exceed. The requirement for a "sole or primary" purpose before the penalties apply is too high a standard, and has been shown to be inadequate in cases in Michigan and California. However, the business community has a concern about "a purpose" being overly broad. There will be confusion if the Washington standard is different than the federal standard. This bill does not address the issues related to professional employer organizations which will be taken up during the interim. These organizations provide human resources services to small employers who do not have their own resources.

Testimony Against: None.

Persons Testifying: Karen Lee, Commissioner, Employment Security Department; Jeff Johnson, Washington State Labor Council; Jim Halstrom, National Association of Professional Employer Organizations; John Eaton; and Mellani McAllenan, Association of Washington Business.

Persons Signed In To Testify But Not Testifying: None.