Combating SUTA Dumping

by D. Larry Crumbley and Fred R. Gamin

D. Larry Crumbley, Louisiana State University, and Fred R. Gamin, with the North Carolina Employment Security Commission, say that unemployment insurance plays a vital role in the economy and look at how states can more effectively oppose unemployment tax avoidance schemes.

Some tax shelter strategies pushed by major public accounting firms involve avoiding unemployment insurance taxes. A company transfers employees from one entity that has had rapid turnover or many layoffs with a 5.7 percent unemployment tax rate to another newly created entity with little layoff history and a lower 1.2 percent unemployment rate. A North Carolina company with 2,000 employees would have an unemployment tax bill of $1.8 million at the higher rate and only $384,000 at the lower rate.1

In 2004, Labor Secretary Elaine Chao told the House Ways and Means Committee that if states were aggressive, they could collect "tax payments of over $200 million annually from employers who are not playing by the rules."2 As an example, the Texas Workforce Commission announced in February 2005 that the Texas Third Court of Appeal upheld a lower court decision refusing Berry GP Inc. a refund of $1.9 million.3

Berry GP created a new company with only two employees; a few weeks later it transferred the remaining 3,000 Berry GP employees into the new company. The appeal court's opinion stated, "To base appellant's compensation experience rating on the two employees transferred first, rather than the 3,000 employees transferred second, would defeat the purpose of rewarding employers who have earned a favorable tax rate."4

American Unemployment Insurance -- Past, Present, and Future

Many tax practitioners are not particularly familiar with unemployment insurance (UI) and the nature of its distinctive third-party insurance contract. Unemployment compensation is old law from an old era when the New Deal was new. No longer young, UI has very recently become a dynamic and thriving corner of the law. UI law is intricate, though not especially complex, with some crucial basic definitions that have been in use since its inception. For instance, state unemployment tax or UI tax has always been officially known as "contributions" under North Carolina law as well as in many other states.5 There is no official history of how the term "contribution" came to be used in the Social Security Act. Nevertheless, it may be that those who drafted the New Deal bill wanted to reflect the fraternal and associational origins of modern insurance or perhaps they wanted to deflect the opposition to another tax on employers no matter how modest it was originally. In 1937 the presumptive SUTA contribution was only 1.8 percent, rising to 2.7 percent in 1938. The 1937 net FUTA contribution was 0.1 percent, rising to 0.2 percent in 1938 and 0.3 percent in 1939.

Along with Medicaid, Social Security, and welfare, the UI system provides the basic societal safety net that rests beneath the American workforce. UI is made more intricate by its transgovernmental overlay, but the fundamental idea behind UI is simple. The general consensus holds: If employees lose their jobs through no fault of their own, they ought to receive a salary continuation for some specific period. In theory, the amount of the benefit should be large enough to pay a worker's nondeferrable living expenses but not so much money as to discourage the worker from seeking work. After all, it is designed to maintain or at least foster an unemployed worker's connection to the workforce, not to entice the worker to permanently remain separated from productive work. As a rule of thumb, workers near the bottom of the wage scale receive approximately half of their recent wage.

However, there is no uniformity in benefits from state to state. With differing formulas using annual, weekly, and quarterly wage figures, the maximum weekly benefit (the point above which workers will not receive half of their weekly pay) varies greatly as shown by the Alabama maximum UI benefit of $220 for 2005 as randomly compared with other venues. Puerto Rico was $133, New York was $405, New Jersey was $503, Utah was $371, California was $450, Ohio was $446, Iowa was $381, and North Carolina was $426 for calendar year 2005.6

The amount and duration of the salary continuation known as "benefits" varies from state to state within limits. Contributions are the mandatory premiums (the tax) paid by employers to insure that their employees may receive the benefits. Though economists might argue that in a hypothetically perfect world all end-users ultimately pay the costs of goods and services, in this case the law prevents employers from directly passing the cost of UI benefits on to its employees past or present. In fact, the employer has no direct control over immediate benefit payouts. Benefits are paid from special statutory trust funds under the control of the states and the federal government. The states, Puerto Rico, the District of Columbia, and federal employers all participate in the trust fund financing system. The benefits are initially paid by the government, usually the state, from funds held by the government. Today, many benefit claims are made or "taken" over the Internet, by telephone, or at government UI offices that are often called job service or workforce centers.7

This short review of the UI system shows that the term contributions is an apt name for a job insurance premium designed to reimburse the government for the actual cost of benefits paid out to each employer's laid-off workforce. Franklin Delano Roosevelt considered it to be insurance -- not just another tax. In 1932, as part of his original campaign against President Hoover, he pledged to create a national unemployment insurance system financed by employers.8 His plan became part of the Social Security Act of 1935; the states were and are free to choose other similar actuarially sound ways to fund their insurance program, but most state unemployment insurance programs remain remarkably similar.9 After the passage of the original federal act, the Social Security Board made model legislation available to the states. That model legislation remains the core of most states' UI laws.

Today, most of the quarterly UI contributions paid out by employers to reimburse the government are called "taxes." Supporting that tendency are state courts that have ruled that contributions are taxes.10 Those court systems treat the UI premium as a tax because of the nonvoluntary nature of those contributions. Still, the tax-like characteristics of UI payments do not belie the fundamental and underlying insurance core of the program. Generally, even dedicated taxes such as road funds involve compulsory payments for some larger societal purpose, something beyond one's own keen and beyond the control of any individual that is the source of the tax payment. Employers in their various roles as non-UI taxpayers are subject to many factors that determine the actual amounts of tax paid. Often, the aggregate tax levied is largely a function of the intended use of the tax levy quite apart from the taxpayer. In that sense, taxes are not directly tied to any one taxpayer's own experience or situation. Property taxes financing public schools are an example: The property owner owes the tax regardless of whether she may ever set foot in a public school or have students.

However, UI contributions are directly tied to the employer in the form of the cost of benefits paid to the taxpayer's former employees. While one might quibble that an employer's former workforce is not ultimately and directly tied to that employer, that complaint misses the relevant point illustrated by the following example. There is such a close connection between an employer and its former workforce that when negotiating with alleged SUTA dumping violators, the senior tax managers representing North Carolina do remind employers/taxpayers that there are only three ways for an existing business to manage (read "reduce") UI costs in North Carolina. And none of the permissible ways include tax manipulations or tax shelters. An employer may lower its UI taxes or contributions by stabilizing its workforce. Two ways to minimize costs involve workforce stability. The first way is to minimize employee turnover. When no employees are separated from their jobs, there will be no benefit charges against the employer's tax account. The second way is to aggressively defend against unjustified UI claims. When employers either ignore or do a bad job of arguing their cases before UI administrators, expensive things can happen. Employees who have exhibited substantial fault or on-the-job misconduct get benefits because their employers fail to make accurate records, fail to communicate with the taxing authority, fail to attend hearings, or fail to bring documentation and eyewitnesses to due process hearings. Only a few failures to fight against wrongful or undeserved claims can lead to major increases in the employer's UI tax rate. That is true in almost all jurisdictions. One of the authors spent time as chief appeals referee for

North Carolina and now handles appeals in court. It is his experience that there is a vast variety in the quality and rigor in which different employers protect their opportunities for good (low) tax rates.

The third way to achieve lower rates is to make a voluntary contribution to reduce the tax. In North Carolina that is most effectively done at the beginning of the tax year. That procedure is available in many but not all states, and each employer's situation must be calculated separately.

Said differently, a North Carolina employer can attain a good tax rate in only one of three ways: stable employment, proper opposition to UI claims, and voluntary contributions. Those employers who believe that they can lower rates or shed their liability for previously paid claims (the experience rating system) by reorganizing their business or shifting workforce while maintaining common law control over their workers, face civil and criminal penalties.

One point of this article is to warn that in North Carolina (as in so many other states) there are lawful and illegal ways to lower UI taxes. Tax practitioners should understand the difference. UI taxes are or ought to be a function of an employer's track record of employee separation (called an experience rating).11 The government has a profile of almost all employer workforces based on the UI tax returns filed every quarter showing employees by name, Social Security numbers, and wages earned. Over time that history amounts to a detailed profile of employee movements across the business landscape.

What Is SUTA Dumping?

Essentially, SUTA dumping is a tax evasion plan used by some employers to lower their UI tax rate in order to avoid paying higher UI taxes. By engaging in tax rate manipulation those employers pass their UI tax liability to the other employers in the state. The SUTA Dumping Prevention Act of 2004 was signed into law on August 9, 2004. States were required by January 1, 2006, to (1) prohibit practices that allow employers to pay lower state unemployment taxes than their unemployment experience otherwise allows, (2) develop procedures to detect such schemes, and (3) impose penalties on employers and financial advisers for knowingly violating or trying to violate the state laws. Essentially, the law requires experience rating to be transferred when employees move from one business unit to another owned or controlled by the same employer.

Although SUTA dumping started at least a decade ago, some CPA firms and advisers began in the late 1990s to advise clients to transfer employees from one entity that has experienced high layoffs to a new entity with little or no layoff history. Eventually, the old entity could be eliminated. One CPA firm's sales pitch suggested "state unemployment tax savings between $6.4 to $7.2 million over the next five years."

That tax shelter pitch suggested two strategies: implement stable/seasonal employee split; or implement entity rotation strategy.

Strategy 1 suggests that ABC Corp. separate its employees, in addition to selected assets, into Stable and Seasonal LLC. Segmenting seasonal employees from stable employees allows the company to separate itself from high unemployment tax experience history and obtain short-term saving and recurring savings. The companies with high layoff rates are taxed at higher rates than those who have low layoff rates. New companies with no experiences may be taxed at a rate somewhere between the two.

Limited liability companies can be disregarded for federal and most state income tax purposes.

Strategy 2 suggests transferring stable employees and some assets to a new LLC and transferring the remaining employees to another LLC. The LLCs are treated as divisions for federal and most state income tax purposes. The LLCs will initially be assigned new state unemployment insurance (SUI) rate, but because of the stable employment, the SUI rate for the stable LLC should decrease to the minimum within three years. At the end of three years, Seasonal LLC will merge into Stable, LLC. Thereafter, repeat the process at the beginning of each year.

The California Employment Department Internet site provides eight possible SUTA dumping schemes:12

Purchased Shell Transaction

A business with a large payroll and a high UI rate purchases a corporate shell with a low UI rate and transfers its payroll to the purchased entity.

Affiliated Shell Transaction

A new corporation is registered, and a small payroll is reported each year until a low or minimum UI rate is achieved. Once the low rate is achieved, large payroll amounts from another related corporation are transferred into this account.

New Employer Rate

An employer with a huge UI rate files a registration form requesting a new employer account number, which has a lower rate (new employers pay 3.4 percent in California), then the payroll is transferred to the new account.

Reporting Under a Client's Employer Account Number

An employee leasing company or professional employer organization (PEO) with a high UI rate shifts its payroll to the account number of one of its clients with a lower UI rate.

High Plus High Equals Low

A high UI rate account with a large payroll is transferred into another high UI rate account with a small payroll at the beginning of the year. Because the calculation of the average base payroll is on a calendar-year basis, only the small payroll is considered. However, the taxes from the large payroll are added to the reserve account balance as of June 30, resulting in a very low UI rate being established for the next year.

Payroll Parking

Two unrelated businesses negotiate (for a fee) to have all or part of the higher UI rate employer's payroll "parked" in the other's account and reported at the lower UI rate.

Partial Reserve Account Acquisition

A newly registered business applies for a partial reserve account balance of another company. When the small reserve balance is acquired, a correspondingly small average base payroll is also acquired. A related entity then shifts hundreds of millions of payroll into the small account. Because the average base payroll is tallied on a calendar-year basis and reserve accounts accumulate quarterly, the result is to flood the reserve balance in relation to the small average base payroll. A minimum rate is attained in the succeeding year.

Buffering Potential Negative Reserve Account Charges

A company that hires temporary workers forms a new entity and obtains a separate account number. The temporary workers are paid through that account. When they are laid off and file UI claims, the newly formed company goes out of business and the negative reserve account charges get distributed to other businesses in the state. That typically occurs when a labor action is contemplated and temporary workers are hired knowing they will be laid off after the labor action. Another variation on this scheme is when a company is planning to downsize. Employees to be laid off are transferred to a subsidiary account. That buffers the reserve account of the initial company from UI charges.

SUTA dumping losses have been huge. California estimated its 2003 losses at $100 million. Michigan estimates its losses at $60 million to $90 million a year, and Colorado estimates losses in excess of $40 million. One company, Kelly Services, would have saved $30 million annually by engaging in SUTA dumping.13 The 2004 act deterred some of the SUTA dumpers, but "cases are getting bigger and harder," says David L. Clegg, deputy chair of the North Carolina Employment Security Commission.14 Carl T. Camden, president and CEO of Kelly

Services, says that some companies are turning to employee-leasing firms to avoid SUTA taxes and some are forming separate corporations for each of its deals.15 Kelly Services Vice President Matt Harvill is given credit for helping outlaw that practice by giving a 90-minute presentation to a half-dozen Labor Department officials in Washington in February 2002, explaining how companies were evading unemployment taxes.16

The evasion of legitimate UI taxes amounts to a government-financed get-rich-quick scheme. In the short term, evasion denies the government money needed to fund the system. In the longer run, evasion punishes honest employers and makes all other employers bear the burden belonging to the tax evader. That point was made by Camden when he said in effect that turning a blind eye to SUTA dumping would be forcing his company to such a substantial competitive disadvantage in the workforce industry that the only rational course of action for Kelly Services would be to engage in the same tax cheating that he condemned if Congress and the states did not stop SUTA dumping.17

Feds Must Do More

In 1935 Congress established the general framework for a joint state and federal job insurance program financed by employers covering their own separated workers. The UI program, a component of the Social Security Act of 1935, was designed to be administered by the states and supervised by the federal government. For the first 65 years of its existence, that interesting and perhaps unique joint tax collection and benefit administrative partnership has worked relatively well. Recently, Congress recognized that a segment of the employers has avoided and evaded perhaps billions of dollars in UI contributory taxes.

Its response was to create a nearly unfunded mandate directing the states to clean up the corruption, collect the tax, bust the tax shelters, and convict the criminals. In fairness to the federal government, it did finance the enhancement and dissemination of the computer detection program that North Carolina designed to identify the movement and transfer of employees as reported on employer quarterly tax returns. Of course, the program does not by itself show that there has been a violation of the tax law. But the program can identify patterns of conduct that permit and facilitate tax manipulation.

Also, federal officials at the U.S. Department of Labor (DOL) did fight for a training money appropriation that was made available to every state. However, the congressional legislation did not provide any money for additional state investigators or prosecutors. Nor did that federal legislation do anything to enhance the federal civil or criminal footprint over UI tax shelters and evasion. If Congress really wants more federal UI tax enforcement, state UI regulators should not be left to beg the FBI and their local U.S. attorneys for help.

The fundamental problem may be that the UI system has functioned so long and so well with strong compliance and without extensive enforcement that few federal officials understand the need for a substantial commitment of resources and people. Even North Carolina's SUTA dumping enforcement group is not exclusively assigned to that effort -- each member has separate duties. Many simply work extra hours. The problem may be best summed up in the words of a federal official who was asked to support more resource for SUTA dumping enforcement and said, "Well, once the employers see the results of your computer program, they will sit down and write a check." Regrettably, it is never that easy in practice. So far, North Carolina recovered $21 million in a two-and-a-half-year enforcement effort, but in more than 45 completed investigations never have the taxpayer/employers or their lawyers opened their checkbook as soon as the state's investigative auditors explained their liability. Mostly, violators have to be figuratively (and courteously) hit over the head with the truth. That can be a protracted process especially when the state agency has none of the hard-won enforcement reputation of the FBI or Securities and Exchange Commission.

Returning to the origin of the UI program, the 1935 Social Security Act contained no introductory or formal statement of its purposes. That was left to the individual states because it was always understood that the UI portions of the act was authorizing legislation that would soon be followed by enabling acts by each of the adopting states. The Social Security Board prepared model acts for the states that followed the same lines as early commentary stressing protection against the hazards of unemployment, maintenance of purchasing power, and economic stabilization.18 The North Carolina experience was typical. The state had a formal statement of purposes for its UI law, officially known as the Employment Security Law.19

One of the most sophisticated restatements of the purposes of UI is in a 1950 Federal Bureau of Employment Security document. "By maintaining essential consumer purchasing power -- on which production plans are based, the program provides a brake on downturns in business activity, helps to stabilize employment, and lessens the momentum of deflation during periods of recession."20

In 1936, North Carolina UI insurance coverage did not apply unless an employer had eight employees.21 Today, even one employee can be covered. Federal law also dramatically expanded the duration of coverage. In 1958 the regular or standard maximum duration for benefits was still 26 weeks. Congress then passed the first extended benefits program. Each state could participate voluntarily, borrowing federal funds and making interest-free repayments to the federal trust fund. A permanent extended benefits program was finally passed in 1970. The extended benefits were for an additional 13 weeks with the cost shared equally by the states and federal government and a 0.1 percent increase in the FUTA tax to cover the federal costs. During recessionary periods in the 1970s, 1980s, and 1990s, the federal government passed a supplemental benefits program that extended available benefits beyond 39 weeks without any state contribution. That expansion of benefits greatly enhances the effect of the UI system as an automatic economic stabilizer.22 From a simple short-term supplemental income replacement in 1936, the UI program has expanded into a major countercyclical automatic economic stabilizer.

The UI insurance program stabilizes the economy by increasing benefit payments and lowering employer taxes during recessions. In 2000, North Carolina paid $490 million in benefits. The entire United States paid out $20.5 billion. In the recession year 2001, North Carolina paid out nearly twice the amount of benefits, $940 million. The U.S. total was $28.7 billion for 2001, indicating that unemployment hit North Carolina much more sharply than the nation as a whole. North Carolina unemployment benefit payments peaked in 2002 at $1.21 billion, stayed the same in 2003, and fell to $900 million in 2004. Total U.S. benefits peaked a year later. In 2002 the total U.S. figure was $35.4 billion. The 2003 figure was $41.3 billion and the 2004 figure was $34.3 billion.23 While those dollar amounts might not seem powerful in an economy that is $6 trillion per annum, other factors must be considered. In 1950 only 60 percent of civilian labor force was covered by UI. By 1997 it had become truly ubiquitous at 90 percent coverage.24

North Carolina Takes the Lead With SDDS

The state of North Carolina has been out front in cracking down on SUTA dumping. In May 2003, North Carolina became the first state to make the practice a felony, carrying a presumptive sentence of six months incarceration along with harsh civil penalties. North Carolina recovered more than $9 million in several antidumping actions and had more than 200 other suits by October 2005.25 Recently, North Carolina settled an antidumping claim for more than $8 million.

The DOL has given nearly $5 million of grants to states to encourage enforcement efforts. North Carolina used an award to develop SUTA dumping detection software that the DOL makes available to other states.26 The software tracks employees using Social Security numbers. If too many employees move from one entity to another entity, a red flag goes up. The system tracks SUTA activity and employee movement.

Called the SUTA Dumping Detection System (SDDS), the software can be installed and implemented by all states at minimal cost. SDDS is a server-based system with a browser interface that compares extract data from a state's mainframe tax system to a variety of criteria that may indicate tax rate manipulation activity (SUTA dumping). A minimum of 3 years (12 quarters) of data are needed. North Carolina used 12 years (120 quarters) in the pilot study. Seven states -- North Carolina, Nebraska, Rhode Island, Texas, Utah, Virginia, and Washington -- tested the SDDS application from June 2004 to April 2005.27

Six of the seven states thought the pilot program was a positive experience, but the seventh state thought that the number of releases detracted from the testing, and too much information was returned from the searches to make it useful. All states reported that the system flagged accounts that had previously been identified for investigation. Six states reported that new cases were identified for further research. At least 45 states have requested SDDS so far.

North Carolina uses the SDDS to provide quickly accessed interpreted screens that reflect changes in employment, wages, taxes, and benefits charged in employer accounts that have experienced employee movements. The SDDS assists in the identification of SUTA schemes by presenting, in one application, all information available from the tax, wage record, and the benefits charged systems. In North Carolina, as a reserve ratio state, information from companies that report zero wages but continue to accrue benefit charges against their accounts can be quickly accessed through the search features of the system.28 Search queries may be based on, but not limited to, time frame, movement rate, predecessor/successor relationships, voluntary contributions in excess of prior year taxes due, and tax rate changes. SDDS searches can also be queried by entering the account to help UI staff, analysts, and auditors determine whether further or ongoing investigation of account activity is recommended for SUTA dumping detection purposes. If an employer account activity is determined to rise to the level of an investigation, all pertinent SDDS screens, mainframe screens, imaged source documents, secretary of state documents, employer Web site screens, SEC annual reports, and other documents are prepared for the forensic investigation.29

Substantial Common Ownership, Management, or Control

Under the SUTA Dumping Prevention Act the unemployment experience must be transferred if an employer transfers its business to another employer and both employers are under "substantially, common ownership, management, and control."30 Under North Carolina employment security law, control of a business entity "may occur by means of ownership of the organization conducting the business enterprise, security arrangements or lease arrangements covering assets necessary to conduct the business enterprise, or a contract when the ownership, stated arrangements, or contract provide for or allow direction of the internal affairs or conduct of the business enterprise"31

Under North Carolina law, continuity of control "will exist if one or more persons, entities, or other organizations control the business enterprise after an acquisition or shall include, but not be limited to, changes of an individual proprietorship to a corporation, partnership, limited liability company, association, or estate, or the addition, deletion, or change of partners; a limited liability company to an individual proprietorship, partnership, corporation, association, estate, or to another limited liability company, a corporation to an individual proprietorship, partnership, limited liability company, association, estate, or to another corporation or from any form to another form."32

Thus, once a North Carolina auditor suspects SUTA dumping has occurred, evidence must be accumulated to show a continuity of control. Field investigation of SUTA dumping cases involves extensive document review, interviews, analysis, and composition of reports. Auditors assigned to those cases must be among the best and the brightest for the effort to succeed. Inherent in those forensic-type investigations is the critical need for the auditors to understand and be able to discuss legal structures such as LLCs, corporations, partnerships, and parent-subsidiary relationships. Also, the fraud auditor must be knowledgeable of reporting requirements of the Internal Revenue Service and other state agencies as they pertain to the employer's structure.

In some disputes, subpoenas may be needed to move the process forward. Auditors must be prepared to be a witness if a dispute goes to hearing or the courtroom.33 A deposition may be necessary.

Front companies may be used to disguise a successor company. One of the most important considerations in deciding whether businesses are commonly controlled is continuity of ownership. There are several forms under which businesses organize or reorganize themselves. Those forms include proprietorship, corporations, associations, estates, LLCs, partnerships, changed partnerships, and estates. Any change in the organizational forms of a business is evidence of continuity of control between the original and transformed businesses. There are many factors an auditor must take into consideration in making a determination. No one factor is controlling. Rather, the determination is made from all of the evidence in a case.

North Carolina takes the position that the basis of common control is some direct or indirect authority over the workforce of the various businesses. An auditor must decide if some entity or person with connections to the business has the direct right to control the workforce. That does not mean that the controlling party must exercise power over all or any part of the entire workforce. The controlling party does not have to actually exercise its power. Latent control is sufficient to establish control. Having the power to direct the use of business revenue is evidence of control of revenue and the workforce.

There are many organizational, operational, and related-party considerations that identify "links" to the predecessor company (that is, the secondary company formed to be an alter ego). R.J. Montgomery and W.J. Majeski suggest 14 different organizational considerations (for example, common officers and directors) and more than 50 operational considerations (for example, common product lines) to help establish links to the predecessor company. They provide at least 20 related-party transactions that auditors may be able to discuss.34

Auditors can demonstrate continuity-of-interest links from reviewing a company's federal income tax returns, especially the new Schedule M-3. A frame of reference is to determine if a transfer of assets and/or employees was a reorganization or sale. If a reorganization is tax-free and thereby meets the 50 percent continuity of interest rule, the necessary continuity of interest is sufficient for UI purposes. An auditor should look for section 351 transactions, double dummy mergers (for example, 70 percent cash), section 304 transactions, and golden parachute payments. Auditors may use the substance-over-form, business purpose, and step transaction doctrines to prove their case.

Limited Liability Companies

A favorite entity used by SUTA dumpers is the LLC. In North Carolina a single-member LLC owner who wants to avoid the presumption that it is the LLC employer for UI tax purposes must prove that the LLC has a level of financial and managerial independence that has not yet been shown by any single-member LLC under investigation. The owner has the burden of showing that the LLC is entirely and completely independent of the owner -- a difficult burden. Without that independence, the single-member owner pays the North Carolina UI taxes on the LLC workforce.

Independence does not appear to exist in the typical situation of a single-member LLC that makes the default election to be treated as a disregarded entity for federal income and employment tax purposes. As a disregarded entity, the LLC's revenue flows through to the owner, who has total control of the income.

Further, the LLC owner retains a duty to pay federal employment taxes. Those taxes include FICA taxes imposed under the Federal Insurance Contributions Act, federal income tax withholding under the Internal Revenue Code, and the FUTA taxes.35 Although the IRS initially allows employment taxes to be paid at the LLC level, Treasury regulations and IRS notices make it clear that the owner of a single-member LLC is ultimately responsible for the FUTA tax as well as the other employment taxes.36

In a similar fashion, LLCs' owners are responsible for North Carolina UI or SUTA taxes. This obligation is not an emulation of federal practice. Rather, it is civil duty that may be imposed by the conduct and operating choices of the owner. If the owner treats the LLC's business as a dependent branch, division, or unincorporated subsidiary of itself, that may be reflected in the federal tax treatment it elects and it will be reflected in how it handles money.

Of course, an owner may choose the opposite federal tax election and still achieve the same practical result. The LLC can elect to be taxed as an association or a corporation but then ignore its independent corporate federal tax status. It does that by choosing to be taxed as an affiliated and consolidated subsidiary. Such voluntary subordination tends to show that the LLC is not independent of its parent entity.

Equally relevant and inseparable is the nature of managerial control of the single-member LLC. Whenever the LLC's management operates at the absolute will and pleasure of its owner, it is unrealistic to suggest that the LLC has operational independence. Likewise, whenever the corporate management of the single-member owner installs itself as the LLC's own management, the LLC is a mere alter ego of the owner. The opportunity to use LLCs to lawfully avoid legal liabilities should not include the ability to evade UI taxes.

IRS Enforcement Needed

The IRS could help states' SUTA dumping enforcement effort and promote a general crackdown on questionable employment tax practices by lobbying the Justice Department to support federal criminal prosecutions and by taking assertive enforcement action on the 10 percent reduction in FUTA credit for late SUTA payments. First of all, the term "10 percent reduction in FUTA credit" can have different results under different interpretations. For instance, the 10 percent reduction could be based on the entire SUTA tax bill -- not just the initial tax.

North Carolina has one account that owes $12 million plus $13 million more in additional penalties and interest. The 10 percent reduction could grow over time while the employer would receive a rolling reduction in its past credit. North Carolina has computers that can work out those calculations. Violators could have growing IRS delinquencies that the IRS could enforce.

Finally, it is not clear that the IRS has exhausted all possible avenues for criminal and civil penalties available in the SUTA/FUTA area. The federal government can prosecute criminally in federal court for fraud in several situations.

SUTA dumpers have separately engaged in combination with other employers to file false tax documents to evade (1) federal unemployment tax payments due directly to the United States, and (2) federal unemployment tax payments due the United States indirectly through the North Carolina employment security system. That conduct is in direct violation of 18 U.S.C. section 1001 (it is unlawful to file a false federal statement).37

In Herring, the Eleventh Circuit rejected an earlier Ninth Circuit holding that the false filing crime did not apply to the UI system because there was only federal oversight but no federal operation involvement in the UI system. The Eleventh Circuit rejected the earlier decision by holding that there was UI system federal operational involvement. That included the receipt of federal funds by the state as well as a claimant's ability to receive UI benefits on an interest basis. The effect of Herring is that a claimant's false statement to the Georgia Department of Labor could support a federal indictment for filing false state unemployment documents under 18 U.S.C. section 1001. An employer has no less federal liability for corrupt conduct.

Conclusion

In sum, UI benefits as a nearly universal job insurance program can act as an effective stimulus to our economy in a decidedly "non-trickle-down" fashion. When the economic indicators turn bad, increased UI benefits are injected into the economy at thousands of crucial points. In each of the major recessions of the 1970s, 1980s, and 1990s, regular UI benefits reached 5 million worker-producers. At least 5.3 million received UI in the second quarter of 1975, 5.1 million received UI in the first quarter of 1983, and 4.7 million in the first quarter of 1992.38 Therefore, UI benefits are placed in the hands of producers seeking to retain their proper place and dignity in our consumer society. Those benefits flow right back into the economy and help both it and those recipients to survive.

The job of the federal government and the state and local agencies is to administer the employment security law to preserve and protect the financial integrity of UI and its critical benefit reimbursement system. They face a critical task that will even more closely begin resembling the duties and burdens of the IRS.

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FOOTNOTES

1 Kimberly Pierceall, "States Try to Abolish Practice of Cutting Unemployment Tax," Wall Street Journal, Mar. 19, 2004.

2 Ibid.

3 Texas Workforce Press Release, "TWC Wins Court Case," Feb. 4, 2005.

4 Ibid.

5 Not all dollars collected by state governments in connection with UI benefits are considered as taxes for all purposes. In New Jersey Department of Labor, Petitioner v. Reconstituted Committee of Unsecured Creditors of the United Healthcare System Inc., 396 F.3d 247 (3d Cir. 2005), a three-judge panel of the Third Circuit (C.J. dissenting) held that a not-for-profit employer who elected to make exact dollar-for-dollar reimbursements for benefits paid in lieu of contributions was not paying a tax subject to bankruptcy priorities.

In addition to establishing the federal unemployment tax, FUTA governs many aspects of state unemployment compensation systems, including how state unemployment compensation laws treat non-profit organizations. Each state must provide organizations exempted from federal unemployment tax pursuant to 26 U.S.C. section 3306(c)(8) with the opportunity to elect to make reimbursement payments in lieu of contributions. 26 U.S.C. section 3309(a).

Id. at 250-251. . . . [R]ather than a tax, the reimbursement obligation is more like a promise in exchange for the privilege of employing individuals in the state without being required to pay state unemployment compensation contributions. The state will allow a non-profit employer to conduct business without making contributions to the state unemployment compensation [U.C.] fund, and the state will pay the [U.C.] benefits due to the non-profit employer's former employees, but this creates a debt, and the state insists on being repaid.

Id. at p 260.

The Supreme Court denied certiorari on October 3, 2005. All jurisdictions allow some special treatment of the UI benefit burden to two special groups, nonprofits and governments. Presumably, the benefit experience rating systems that are used to determine the tax rates of private industry while helping to stabilize the economy are less appropriate in the case of nonprofits and governments. All the states' systems allow governmental entities and non-profits to pay dollar-for-dollar reimbursements for benefits paid out. Normally, reimbursement is due at the end of each quarter. Some states have nonprofit or government flat "tax" options for UI benefits. See Fn. 6 infra, Highlights of State Unemployment Compensation Laws January 2005, p. 40.

6 Highlights of State Unemployment Compensation Laws January 2005, National Foundation for Unemployment Compensation & Workers Compensation, pp. 50-52. One of the most comprehensive sources for unemployment system statistics, measurements, mechanics, and requirements, this publication is available for purchase at http://www.UWCstrategy.org.

7 The following is summary text from two parts of Highlights January 2005. The first excerpt is from the introductory "Overview," pp. 1-3, and the second is from "Table 7 -- Rates for New Employers," pp. 18-19.

STRUCTURE

Both the federal and state governments have important responsibilities for unemployment compensation. The program is administered pursuant to state law. Each state law prescribes the tax structure, qualifying requirements, benefit levels and disqualification provisions. The states' laws must, however, conform to federal requirements. The Federal Unemployment Tax Act (FUTA) imposes an unemployment (payroll) tax but allows employers an offset against the federal tax if they are paying taxes under an approved state unemployment compensation law.

COVERAGE

With the exception of workers on small farms, and a number of minor categories of services, unemployment insurance coverage is practically universal.

BENEFITS

The generally accepted objective of the weekly benefit amount is to provide a wage replacement that is high enough to cover the claimant's non-deferrable expenses, but not so high as to undermine his or her incentive to return to work. Usually, this translates into a weekly benefit equal to about 50 percent of the claimant's normal weekly wage.

All states now provide potential duration of at least 26 weeks.

ELIGIBILITY AND DISQUALIFICATIONS

All claimants, in order to qualify for benefits, must be able to work and available for suitable work.

RATES FOR NEW EMPLOYERS [Selected from complete list]

California 3.4 percent; Idaho 1.5 percent; Illinois Greater of 3.8 percent; Maine Average contribution rate, but not higher than 4 percent or below 1 percent; North Carolina 1.2 percent; Pennsylvania 3.7520 percent; Virgin Island 1.0 percent; Wisconsin 2.7 percent.

8 "This is not a new policy for me. I have advocated it in my own state for sometime. This type of insurance is not a cure all, but it provides at least a cushion to mitigate unemployment in times of depression. It is sound, if after starting it, we stick to the principle of sound insurance financing." campaign speech, Oct. 13, 1932, Annals of America, vol. 15, p. 158.

9 "The unemployment compensation program is financed almost entirely from employer taxes. Alaska and New Jersey also tax employees, and Pennsylvania and West Virginia require employee contributions under certain conditions. The federal tax is 6.2 percent of the first $7,000 in wages paid to each employee. Employers receive credit of up to 5.4 percent for the taxes they pay under state unemployment compensation laws. . . . At the state level, benefits are financed from state-collected employer taxes which, through deposited in the U.S. Treasury, are always available to the state for benefit purposes. . . . Each employer is assigned a particular tax rate based on its experience with unemployment, in relation to the experience of other employers. Experience is measured by the state's experience-rating system. Most states use the reserve ratio system. The amount of benefits charged to an employer is deducted from the amount of taxes it paid. The balance is divided by the employer's potential liability for benefits. State laws provide a variety of circumstances under which employers may be relieved of benefit charges." Highlights January 2005 p. 3. See fn 6 infra.

10 "Clearly the contributions in question constitute an obligation in the nature of excise taxes. The Supreme Court has definitely decided that contributions paid by an employer under the Unemployment Insurance Act constitute excise taxes." (Gillum v. Johnson, 7 Cal.2d 744, 763 [62 P.2d 1037, 63 P.2d 810, 108 A.L.R. 595.]" California Employment Com. v. MacGregor, 64 Cal. App. 2d 691, 695 (Cal. Ct. App. 1944); "The contributions to the [unemployment trust] fund are not voluntary. They are compulsory and constitute a tax." Provident Mut. Life Ins. Co. v. Unemployment Comp. Com, 126 N.J.L. 348 (N.J. 1941); "The "contribution" imposed by the law is a tax." Unemployment Compensation Com. v. L. Harvey & Son Co., 227 N.C. 291, 298 (N.C. 1947); "The contributions, by whatever name designated, are not voluntary but are compulsory and constitute a tax. Nor does the fact that the Legislature has seen fit to segregate the funds derived from the collection of the contributions assessed in a special fund and for a special purpose alter this conclusion." Prudential Ins. Co. v. Powell, 217 N.C. 495, 499 (N.C. 1940).

11 See fn. 9. Nonprofits and government entities are allowed to avoid the experience rating system and simply pay for benefits by reimbursing the agency on a dollar-for-dollar basis.

12 "SUTA Dumping and Unemployment Insurance (UI) Rate Manipulation," http://www.edd.ca.gov/taxrep/txueosd.htm

13 "Many Bills Falling Short at Protecting State Trust Funds, Workers, and Employers," National Employment Law Project.

14 A.B. Crenshaw, "Unemployment Taxes Evaded," http://www.Washingtonpost.com, June 15, 2005.

15 Ibid.

16 Michael Schroeder, "Kelly Services Fights to Close Costly Tax Loophole," The Wall Street Journal, Aug. 4, 2004.

17 Ibid.

18 L. Chimerine, T. S. Black, and L. Coffey, Unemployment Insurance as An Economic Stabilizer: Evidence of Effectiveness Over Three Decades, Unemployment Insurance Occasional Paper 99-8, U.S. Department of Labor, Washington, D.C., 1999, p. 13.

19 N.C.G.S. section 96-9.

20 U.S. Department of Labor, Bureau of Employment Security 1950b, p.1.

21 N.C.G.S. section 96-9 (1936).

22 Chimerine et al., pp. 13-14.

23 U.S. Department of Labor, Office of Workforce Security, Division of Actuarial Services, Unemployment Insurance Data Base.

24 Chimerine et al., p. 22.

25 Greenberg Trauring LLP, "State Anti-SUTA Dumping Legislation and Enforcement Proceedings on the Rise," GT Alert, October 2005.

26 Ibid.

27 U.S. Department of Labor, Region 5 ETA Workforce Letter 012-05, May 19, 2005, across employer accounts, and the associated tax rate changes. The SDDS uses mainframe information from unemployment insurance tax and benefits systems, quarterly wage records filed by employers, and employee demographics information available in a state.

28 The North Carolina General Statutes uses the reserve ratio of UI method of financing, permits voluntary contributions and assigns annual tax rates effective at the beginning of the year.

29 N.C. Employment Security Commission, "A SUTA Enforcement Experience Booklet," Oct. 6, 2005.

30 I.R.C. section 303(k)(1)(A).

31 N.C. Employment Security Law section 96-9(a)(1) (b)(4)(a1)(1).

32 Ibid., section (2).

33 N.C. Employment Security Commission, "A SUTA Enforcement Experience Booklet," Oct. 6, 2005.

34 R.J. Montgomery and W.J. Majeski, Corporate Investigations, 2nd, Tucson: Lawyers & Judges Publishing Co., 2005, pp. 321-328.

35 Reg section 301.7701-3(a)

36 Notice 99-6, 1999-3 IRB 1; Notice 97-1, 1997-2 IRB 22.

37 Dennis D. Herring v. United States, 916 F.2d 1543 (11th Cir. 1990), cert. denied May 28, 1991, 500 U.S. 946 (1991).

38 Chimerine et al., supra note, pp. 23-24.

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