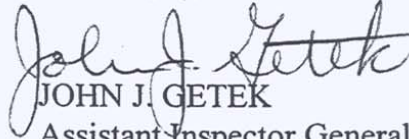




SEP 30 1998

MEMORANDUM FOR: RAYMOND L. BRAMUCCI
Assistant Secretary
for Employment and Training

FROM:


JOHN J. GETEK
Assistant Inspector General
for Audit

SUBJECT: Effect of Employee Leasing on the State of Georgia
Unemployment Insurance Trust Fund
Final Audit Report No. 03-98-007-03-315

The attached subject final report is submitted for your resolution action. We request a response to this report within 60 days.

You are responsible for transmitting a copy of this report to the State of Georgia. However, we have forwarded a complimentary copy.

The assistance provided by Ms. Grace Kilbane, Director, UIS, Mr. Rett Hensley and their staff was greatly appreciated. If you have any questions, please contact Roger B. Langsdale, Regional Inspector for Audit, in Philadelphia at (215) 656-2300.

Attachment

cc: Walter N. Adams, Assistant Commissioner for UI
Rett Hensley, Team Leader, Tax Program Team

***U.S. DEPARTMENT OF LABOR
OFFICE OF INSPECTOR GENERAL***

***EFFECT OF EMPLOYEE LEASING
ON THE STATE OF GEORGIA
UNEMPLOYMENT TRUST FUND***

Final Report Number: 03-98-007-03-315

Issue Date: September 30, 1998

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ACRONYMS

BLS	Bureau of Labor Statistics
CFR	Code of Federal Regulations
DOL-1a	Georgia Department of Labor Employer Status Report
ETA	Employment and Training Administration
GA DOL	Georgia Department of Labor
LIS	Labor Information Systems
Multi-WS	Multiple Worksite
NET	Internet
OIG	Office of Inspector General
SIC	Standard Industrial Classification
UI	Unemployment Insurance
US DOL	United States Department of Labor
UTF	Unemployment Trust Fund

EXECUTIVE SUMMARY

We performed a limited scope audit of the employee leasing industry in the State of Georgia (Georgia) during the 5-year period January 1, 1992 through December 31, 1996. In addition, losses were computed through the end of 1997.

Objectives, Scope and Methodology

Our objective was to determine what effect employee leasing companies had on Georgia's Unemployment Insurance (UI) Trust Fund. Specifically, we wanted to determine what impact employee leasing company operations and "shell" leasing company activities had on Georgia's UI Trust Fund.

Our limited scope audit covered the 5-year period January 1, 1992 through December 31, 1996. We performed additional fieldwork to update the amount of Trust Fund losses due to "shell" activities through 1997.

To achieve our audit objectives, we examined Georgia's UI laws, employer UI tax and employee UI tax records and other independent sources to identify Georgia companies operating within Georgia during our audit period. We applied an algorithm program to all leasing company transactions to identify shell leasing company activities and the overall effect on the UI trust Fund. We did not review or draw any conclusions on the leasing industry as a whole.

Findings and Recommendations

Our limited scope audit disclosed that over the 5-year audit period, Georgia's UI Trust Fund sustained a net loss from leasing company operations of \$164,726 as follows:

- **GAIN** We found a gain to the UI Trust Fund of \$866,546 from **bona fide** leasing company activities. The majority of this gain (\$807,816) was due to a one-time "windfall" which occurred with the transfer of employees from one company to another (leasing company). The "windfall" occurred when two or more employers paid UI tax on an employee's base wages during the same tax year. Another more modest gain of \$58,730 occurred due to the net difference between tax rates paid by the former and the successor employer.
- **LOSS** The above gains were more than offset by losses of \$1,031,272 due to the **"shell" leasing activities** of six leasing companies (affecting approximately 5,837 employees) that **abused the UI system** during our 5-year audit period. (Moreover, we found additional losses in 1997 of \$651,988.) Five of the six "shell" companies were on Georgia's leasing company list and were bonded. The two types of abuses disclosed by our audit were: (1) a leasing company with a high UI tax rate purchasing a business entity "shell" in an unrelated industry with a low UI tax rate not for the purpose of continuing its business but to acquire its low UI tax rate, and (b) affiliated leasing companies transferring employees to the lower UI tax rate and continuing in the leasing business. As a result, we

calculated total losses to the UI Trust Fund of \$1.7 million over a 6-year period ending December 31, 1997, as a result of leasing company "shell" transactions.

- Georgia is one of the few states that require leasing companies be bonded as a means to avoid the risk of uncollectible UI tax in the event of default. However, procedures used to identify leasing companies were ineffective. We found that Georgia had **not identified** 41 percent of the leasing companies found during our audit.

In summary, we found that abusive "shell" transactions resulted in a \$1,683,260 loss to the UI Trust Fund. Of this, \$79,631 resulted from abusive affiliated "shell" transactions with the remaining \$1,603,629 representing illegal and/or abusive purchased "shell" activities.

In our opinion "shell" leasing activities are abusive and undermine the UI experience rating tax system. The results of our audit indicate that improvements are needed in both operating procedures and in Georgia State law to better identify employee leasing companies subject to the State's bonding requirements and to deter abusive "shell" leasing company activities.

Because of the risk of loss to the UI Trust Fund, we recommend that the Assistant Secretary for Employment and Training work with the Commissioner of Georgia Department of Labor (GA DOL) to accomplish the following:

- Pursue all available remedies pertaining to abusive employee leasing "shell" activities and recover UI Trust Fund losses resulting from violations of Georgia's statute in the amount of \$1,603,629.
- Pursue remedial action to amend the State of Georgia Employment Security Law to prohibit any reduction in UI tax rates caused solely by multiple transfers of employees from one affiliated employee leasing company to another. In this regard, consideration should be given to classifying affiliated leasing companies into one experience rating category to correct inter-affiliate transfer abuses.
- Revise the employer status report to incorporate a question specifically asking employers if they are engaged in the leasing of employees to other employers (client firms).
- Develop written procedures and ensure that:
 - a. employer status reports are thoroughly reviewed for leasing company identification; and
 - b. questionnaires are sent to suspected leasing companies on a regular basis, companies not responding are contacted, and all responses are properly reviewed and accounted for.

Auditee's Response

The Georgia Department of Labor strongly disagreed with our findings and declined to take any action on our recommendations to recover the \$1.6 million in losses that we believe resulted from violations of the State's successorship laws. Georgia also declined to take any remedial actions to strengthen State laws and internal controls, as appropriate, to prevent this type of violation from occurring in the future.

Briefly, Georgia defended the right of any employer with significant, rapidly-growing unemployment tax liabilities to seek the most tax-favorable status available under the law and stated that the tax-saving strategies employed by employee leasing companies are not illegal per se. Georgia responded that this ". . . Report overstates a case for abuses from the employee leasing company industry in Georgia [which represents only about 1/10th of one percent of all active employers in the State]. The practices described are generally legal and are commonly utilized by members of other industries to achieve tax savings." Moreover, Georgia stated that, "It is the position of the Department [Georgia] that the fluctuations identified in the report as "windfall gains" and "losses" are minimal, inconsequential, and immaterial variations in cost to the Georgia DOL [UI] trust fund."

Auditor's Conclusion

We agree with Georgia that any employer has the right to seek the most tax-favorable status available *under the law* and that prudent use of the State's successor statutes to gain favorable tax rate status is not illegal per se.

While we concluded that, overall, the State's UI trust fund benefited from employee leasing activities; we stand by our findings that the improper use of successor rates by employee leasing companies not eligible to use them cost the UI trust fund \$1.6 million. We also stand by our recommendations that the State of Georgia, as part of its stewardship responsibility, attempt to recover these funds, and take action to prevent such abuses in the future.

BACKGROUND

The Unemployment Insurance (UI) system was established in 1935 under the Social Security Act (42 USC 501) and the Wagner-Peyser Act (29 USC 49). The UI system is a unique Federal-state partnership designed to provide temporary compensation to individuals who lost their jobs to help alleviate the effects of unemployment on their families and the local economy. The UI program is mandated by Federal law but is administered by the states under their state laws.

States collect UI taxes from employers and deposit the revenue into the UI Trust Fund which, in turn, is used to finance the program. To varying degrees, states assign tax rates to employers in proportion to their experience with employees' UI claims. Experience rating was established based on the concept that higher risks should be reflected in higher premiums. However, changes in the economy and the workplace are affecting the traditional employer/employee relationship and, therefore, the payment of UI tax. BLS reports a relatively small, for now, but fast-growing trend in the number of employers who are reducing their paid workforce and filling their jobs by "leasing" workers from other companies rather than permanently hiring them.

An employee leasing company is an organization engaged in the business of leasing employees to client firms. Under a typical agreement, an employer contracts with an employee leasing company to supply its workforce needs and then dismisses some or all of its employees. Usually these workers are then hired by the employee leasing company and leased back to the original employer, which is now the client company, on a long-term basis.

Under most leasing agreements, the leasing company pays both the employees' wages and associated payroll taxes, including unemployment and workers' compensation insurance. It also provides employee fringe benefits, such as health and pension coverage. This is done for a set fee (usually a percentage of payroll) as stipulated in the leasing contract. In the State of Georgia, each employer files a Form DOL-4, "Employer's Quarterly Tax and Wage Report" for reporting of wages paid and taxes due with respect to such quarter, listing the name, social security number, and amount of wages paid to each individual employee.

According to Bureau of Labor Statistics (BLS) data, the employee leasing industry has been growing in terms of the number of companies at an average annual rate of 27 percent per year from June 1992 through June 1996. According to a recent article¹, "analysts believe that with total payroll dollars of about \$18 billion nationwide, employee leasing has tapped barely 2 percent of its potential market. They expect the industry to increase revenues and earnings by 30 percent a year for up to the next 10 years." This industry growth has been spurred primarily by increases in employers' cost of employee benefit programs, particularly health and workers' compensation and unemployment insurance. Other factors contributing to this growth rate

¹ David Medina, *Crain's New York Business*, "Employee Leasing Firms' New Lease on Life," June 9, 1997

include employers' high costs of payroll processing, pensions, and human resource administration. Leasing company activities can affect the state UI Trust Fund in three principal ways, one of which is positive and the others which are negative as follows:

POSITIVE: WINDFALL GAIN TO UI TRUST FUND

A windfall gain, which occurs in the year of transfer of an employee, is caused by both the former employer and the employee leasing company paying UI taxes on the taxable wage base in the same year.

The base UI taxable wages in Georgia is set by statute at \$8,500 per employee. A windfall gain to the UI Trust Fund represents the total annual UI taxes paid into the Trust Fund by both the former employers and the employee leasing companies in excess of the amount of UI taxes the former employers would have paid, in the first year, had they not opted to engage the services of an employee leasing company. For example, firm A employed 10 staff and paid UI taxes on the \$8,500 wage base for each employee through the first half of the tax year. It then contracted with firm B, a leasing company, and transferred all 10 of its employees to the leasing company. The leasing company is required to pay UI tax for the 10 transferred employees on the \$8,500 wage base again for the second half of the tax year. This double payment, once by firm A and again by firm B, results in a windfall to the UI Trust Fund.

NEGATIVE: LEASING ACTIVITY LOSSES TO UI TRUST FUND

Leasing Company "Shell" Activities. "Shell" leasing activity occurs when (1) an employee leasing company transfers all or a major portion of its employees to a relatively inactive or dormant company which is owned or purchased by the leasing company to obtain lower UI tax rates; (2) a significant percentage (20 percent or more) of employees are transferred from one employer to another with common ownership and control; and (3) losses to the UI Trust Fund occur because the successor company had a lower UI tax rate than the predecessor. In accordance with the State of Georgia Employment Security Law, the successor is not entitled to the predecessor's UI tax rate unless the successor continues the acquired business. For example, firm C is a dormant photo shop with a low UI tax rate of .06 percent. Firm D is a large employee leasing company with a higher UI tax rate of 3.16 percent. Firm D purchases firm C in December and transfers all its employees to firm C in January, acquiring firm C's .06 percent UI tax rate. Firm D does not continue the operations of the photo shop as required by law in order to acquire firm C's low tax rate, but continues its leasing business. The effect of this transaction is that firm D acquired photo shop firm C (shell) not to engage in the photo business but to acquire firm C's low .06 percent rate, thus causing a loss to the UI Trust Fund.

Affiliated Successor's Use of Predecessor's Lower Tax Rate. Any legal entity that acquires (another entity for purposes of common ownership) by purchase, merger, consolidation or other means, substantially all of the business or assets of any employer *and continues such business* is considered a *successor* to the employer from whom the business was acquired. The former employer whose business was acquired is considered the *predecessor*. The successor employer

is entitled to use the predecessor's lower UI tax rate in accordance with the State of Georgia Employment Security law. While such practice is not illegal, it may be abusive as it applies to affiliated companies. For example, firm E is a leasing company with a UI tax rate of 2.70 percent. Firm F is a leasing company with a low UI tax rate of .06 percent. Firms E and F are affiliated companies with the same officers owning or managing both companies. Firm E transfers all of its employees to Firm F, acquires firm F's low UI rate and continues in the leasing business. This is an affiliated shell transaction which, while not illegal, nevertheless is abusive because it undermines the State's experience rating system designed to assess employers UI tax rates based on contributions and benefits paid, resulting in a loss to the UI Trust Fund.

OBJECTIVES AND CRITERIA

The objective of our audit was to determine what effect employee leasing activities had on the Unemployment Insurance Trust Fund in the State of Georgia. Specifically, we wanted to:

1. identify the universe of employee leasing companies operating within the State during a 5-year period,
2. determine whether "shell" leasing company activities existed, and
3. determine what impact employee leasing company operations and "shell" leasing company activities had on Georgia's UI Trust Fund.

We used the following criteria to achieve our objectives:

- Employment Security Law of Georgia, Official Code of Georgia Annotated (OCGA) (Title 34 Chapter 8)
- Rules of Georgia Department of Labor Employment Security Law (Chapter 300-2)

For purposes of this audit and in consultation with UI national office officials, we defined the term "shell" leasing activity as follows:

- (1) an employee leasing company transfers all or a major portion of its employees to a relatively inactive or dormant company which is owned or purchased by the leasing company to obtain lower UI tax rates,
- (2) a significant percentage (20 percent or more) of employees are transferred from one employer to another with common ownership and control, and
- (3) losses to the UI Trust Fund occur because the successor company has a lower UI tax rate than the predecessor.

In accordance with the State of Georgia Employment Security Law, the successor is not entitled to the predecessor's UI tax rate unless the successor continues the acquired business.

SCOPE AND METHODOLOGY

Our limited scope audit covered the 5-year period January 1, 1992 through December 31, 1996. We performed additional work to update the amount of Trust Fund losses due to “shell” company activities. Calculations of losses found in our scope were extended through Calendar Year 1997. While losses may have extended into 1998, tax data was not available to make such calculations. We performed the following procedures to achieve our audit objectives:

- identified potential leasing companies in the state of Georgia using several different methodologies, including algorithm software developed for this purpose by an economist under contract with the OIG, Internet searches and BLS data. The algorithm program logic defined potential leasing companies as those companies having at least three occurrences of three or more employee transfers from one entity to another in Standard Industrial Classification (SIC) Code 7363 (Help Supply Services) industry and at least five occurrences of five or more employee transfers from one entity to another in the non-7363 SIC code industries. This more stringent algorithm limit placed on the non-7363 SIC code firms was based on the lower probability of leasing activity in the non-service industries,
- examined and compared the lists of leasing companies provided by the State of Georgia and U.S. Bureau of Labor Statistics (BLS), Internet search results, employer multiple worksite reports and employer UI status reports to identify additional employee leasing companies not on Georgia’s list,
- obtained confirmations from potential employee leasing companies to verify the universe of employee leasing companies used to calculate UI Trust Fund gains and losses,
- selected a judgmental sample of 3 leasing companies out of the 232 leasing companies identified during the audit to verify the economist’s calculations. There were 39 employees affected by transfers from 10 client firms to 3 leasing companies we reviewed. For each of the 39 transfers we verified all calculations of Trust Fund gains or losses to UI records and employer UI tax returns,
- assessed the adequacy of the Division of Unemployment Insurance operating procedures to identify leasing companies within the State of Georgia and ensure that statutory bonding requirements were met,
- identified potential employee leasing “shell” companies using another algorithm software program. The algorithm program identified potential “shells” as significant employee movement (20 percent or more of total employment) from one leasing entity to another,

- examined UI records to determine if the company was a “shell” company and determined its effect on the UI Trust Fund, and
- examined Georgia Employment Security Law and regulations (Rules), with particular emphasis on the employee leasing, experience rating, and successorship statutes.

Considering the leasing industry’s growth rate and its potential impact on the UI Trust Fund, we selected the State of Georgia Department of Labor, for a pilot audit. This selection was based on BLS data which, for the period June 1992 through June 1996, ranked Georgia the fifth largest state in terms of the number of leasing companies reported and the second largest in terms of growth rate. State UI wage record retention periods and workers’ compensation rates were also considered in our selection.

Our fieldwork was performed at Georgia Department of Labor, Division of UI during the period August 25, 1997 to February 28, 1998. A meeting was held with Georgia State officials on April 15, 1998, to obtain their comments prior to the completion of the draft audit report.

Our limited scope audit was conducted in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

FINDINGS AND RECOMMENDATIONS

Over the 5-year audit period, the State of Georgia's UI Trust Fund sustained a net loss from leasing company activities of \$164,726 as follows: We found a gain to the UI Trust Fund of \$866,546 from **bona fide** leasing company activities (**see Finding I**). However, these gains were more than offset by losses of \$1,031,272 due to six **leasing companies "shell" activities** (affecting approximately 5,837 employees) found during our audit that **abused the UI system** (**see Finding II**). We also found that Georgia had **not identified** 41 percent of the leasing companies found during our audit (**see Finding III**).

I. THE STATE OF GEORGIA'S UI TRUST FUND BENEFITED FROM BONA FIDE EMPLOYEE LEASING OPERATIONS

For the 5-year period, January 1, 1992 through December 31, 1996, the shifting of employment from client companies to employee leasing companies resulted in a combined net gain to the UI Trust Fund of \$866,546. The majority of this gain (\$807,816) was due to a "windfall" which occurred with the transfer of employees from one company to another (leasing company) during the tax year. This was a result of UI taxes paid into the Trust Fund by both the client and employee leasing companies in excess of taxes paid on the taxable wage base of \$8,500 per employee per year. In addition, for the 5-year period, January 1, 1992 to December 31, 1996, the UI Trust Fund realized a net trust fund gain of \$58,730. This gain occurred due to the net difference between tax rates paid by the former and the successor employer. The major factors contributing to this gain were the preponderance of employee leasing firms being assessed UI taxes at the relatively high new employer rate of 2.64 percent compared to 1.13 percent, which is the average experience tax rate paid for all the firms in our audit. In addition, a strong economy has resulted in an overall reduction in UI experience rates because benefits paid to claimants have fallen.

(A) EMPLOYEE LEASING OPERATIONS RESULTED IN A \$807,816 WINDFALL PROFIT TO THE UI TRUST FUND

For the 5-year period, January 1, 1992 to December 31, 1996, the UI Trust Fund realized a windfall gain of \$807,816. Such windfall gains, which occur only in the year of transfer, are caused by both the former employer and the employee leasing company making UI tax payments on UI base taxable wages in the year employees were transferred to the leasing company.

The UI taxable wage base in Georgia is set by statute at \$8,500 per employee. In the case of multiple employers, each employer is responsible for paying UI taxes on this amount. The windfall gain to the UI Trust Fund represents the total annual UI taxes paid into the Trust Fund by both the client companies and the employee leasing companies in excess of the amount of UI taxes the client employers would have paid had they not opted to engage the services of an employee leasing company.

The \$807,816 windfall gain to the Trust Fund indicates that employees were transferred from the client companies to the leasing companies throughout the year, versus the beginning of the year, which would have resulted in little or no windfall gain.

(B) EMPLOYEE LEASING OPERATIONS RESULTED IN A NET TRUST FUND GAIN OF \$58,730 DUE TO DIFFERENCES IN UI TAX RATES

For the 5-year period, January 1, 1992 to December 31, 1996, the UI Trust Fund realized a net trust fund gain of \$58,730. This net gain was caused in large part by a Trust Fund gain of \$220,398 resulting from employees who were transferred from companies taxed at lower UI tax rates to employee leasing companies taxed at the higher UI new employer tax rates of 2.64 percent. Conversely, a Trust Fund loss of \$161,668 resulted when employees were transferred from employee leasing companies taxed at higher UI experience rates to employee leasing companies taxed at lower UI experience rates.

Sixty-four percent (148) of the 232 leasing companies identified in our audit were assessed the new employer rate at the time employees were transferred from the former employers. This is an extremely high percentage considering that only 32.6 percent of **all** employers were assessed the new employer rate during the period covered in this audit. The high percentage of employee leasing companies assessed at new employer rates may be attributable to the 20 to 30 percent annual growth rate in the employee leasing industry.

In addition to the new employer rates, the gains to the UI Trust Fund were increased due to a good economy and a downward trend in the unemployment rate, which resulted in reductions in the employer experience rates. These experience rate reductions increased the gain to the Trust Fund by increasing the differential between the client employer's lower experience rates and the higher new employer rate assessed the majority of employee leasing companies.

II. EMPLOYEE LEASING COMPANY "SHELL" ACTIVITIES ABUSED THE UI SYSTEM RESULTING IN A \$1,031,272 LOSS TO THE UI TRUST FUND OVER A 5-YEAR PERIOD, WITH AN ADDITIONAL LOSS OF \$651,988 OCCURRING IN 1997

Our audit of employee leasing activity for the period January 1, 1992 through December 31, 1996, determined that, as a result of six abusive "shell" transactions representing approximately 5,837 employees, the UI Trust Fund incurred losses of \$1,031,272. In addition, losses of \$651,988 were incurred for the year 1997. Calculations of losses found in our scope were extended through Calendar Year 1997. While losses may have extended into 1998, tax data was not available to make such calculations. We also considered the issue of windfall profits. Since only 3 percent of the "shell" transaction dollar amounts were potentially subject to windfall, this issue was deemed immaterial and we did not pursue it. Abusive "shell" transactions can occur in industries other than employee leasing; however, we limited our review to the leasing companies identified in our audit. See Background section for a detailed definition.

A "shell" activity as defined for this audit is a significant transfer (20 percent or more) of employees from one company to another purchased or affiliated company for the purpose of reducing UI tax assessments. For the 5-year period, we identified 28 potential "shell" transactions from the universe of 232 employee leasing companies. Based on our review, we determined six of these transactions were abusive, meaning the Georgia experience rating statute for establishing employer UI tax rates was circumvented.

We classified abusive "shell" activity into two categories: (A) purchased "shell" and (B) affiliated "shell" transactions. Five of the six "shell" companies were on the State of Georgia's list of leasing companies and were bonded.

(A) PURCHASED "SHELL" TRANSACTIONS RESULTED IN A LOSS OF \$1,603,629 TO THE UI TRUST FUND OVER A 6-YEAR PERIOD

Our audit disclosed that four of the six employee leasing "shell" transactions were purchases that resulted in Trust Fund losses of \$951,641 over the 5-year audit period. In addition, losses of \$651,988 were incurred for the year 1997. A purchased "shell" transaction, as defined in this audit, occurs when an employee leasing company purchases another company with little or no business activity at a lower UI tax rate and then transfers a significant portion of its employees to the purchased "shell" company in order to reduce UI tax assessments. These four purchased "shell" companies were not continued and were in industries unrelated to the leasing companies' business (warehousing, photography, plastics, and beverage). In all cases, the lower UI tax rate of the purchased company was assigned to the employee leasing company.

The following schedule shows the breakdown of the losses to the UI Trust Fund by purchased "shells" and period of time:

LOSSES TO THE STATE UITF BY PURCHASED "SHELLS"

Shell *	Industry Type	{----- Time Period -----}		Total
		1/01/92 - 12/31/96	1/01/97 - 12/31/97	
III	Beverage	\$105,875	\$75,401	\$181,276
IV	Plastics	\$816,131	\$0	\$816,131
V	Photography	\$0	\$251,516	\$251,516
VI	Warehouse	\$29,635	\$325,071	\$354,706
	Total	\$951,641	\$651,988	\$1,603,629

* Refer to page 14 for Affiliated Shell numbers I and II.

The State of Georgia, Department of Labor Employment Security Law, Title 34, Section 34-8-153 (a) Liability of succeeding employer; computation of rate of contributions states, in part:

"Any corporation, partnership, individual, or other legal entity who acquires by purchase, merger, consolidation, or other means substantially all of the business assets of any employer and who thereafter continues the acquired business shall be deemed to be a successor to the employer from whom the business was acquired. The successor shall acquire the experience rating record of the predecessor. . . ." [Emphasis added.]

The acquisition of the successors' tax rates for the four purchased companies that were not continued by the employee leasing company after the purchase violated the State of Georgia statute, which specifically prohibits a company from acquiring the UI tax rate of another company if the succeeding company does not continue that acquired business.

The employee leasing companies cited above would have had to continue operating the purchased businesses to statutorily justify the lower UI successorship rates.

The reason these purchased "shell" transactions resulted in losses to the State UI Trust Fund was because Georgia Department of Labor, Division of Adjudication did not properly review the employer status reports and, as a result, a lower UI tax rate was improperly assigned to the leasing companies.

(B) AFFILIATED "SHELL" TRANSACTIONS RESULTED IN A \$79,631 LOSS TO THE UI TRUST FUND OVER A 5-YEAR PERIOD BUT THEY WERE NOT EXPRESSLY PROHIBITED IN GEORGIA LAW

Shell numbers I and II of the six identified employee leasing "shell" transactions were affiliated "shell" transactions which resulted in a \$79,631 loss to the UI Trust Fund over a 5-year period. No additional losses were incurred for the year 1997. An affiliated "shell" transaction, as defined in this audit, is any transfer of 20 percent or more of employees from one employee leasing company to another leasing company with common ownership and lower UI tax rates, irrespective of reason, resulting in a Trust Fund loss.

Employee leasing affiliated "shell" losses to the UI Trust Fund occurred because Georgia DOL Employment Security Law does not prohibit such affiliated "shell" transactions. These abusive transactions are not currently addressed in Georgia DOL Employment Security Law. However, it is our understanding from discussions with State officials that the intent of the law was to prohibit such abuses.

The abusive purchased "shell" and affiliated "shell" transactions resulted in \$1,031,272 losses to the UI Trust Fund for the 5-year period covered by our audit. In addition, losses of \$651,988 were incurred for the year 1997. These abusive transactions undermine the UI experience rating system because the losses must be absorbed by other employers who are assessed their UI taxes in accordance with Georgia DOL law.

RECOMMENDATION

We recommend that the Assistant Secretary for Employment and Training work with the Commissioner of Georgia DOL to accomplish the following:

- Pursue all available remedies pertaining to employee leasing "shell" activities and recover UI Trust Fund losses resulting from violations of Georgia's statute in the amount of \$1,603,629.
- Pursue remedial action to amend the State of Georgia Employment Security Law to prohibit any reduction to UI tax rates caused solely by multiple transfers of employees from one affiliated employee leasing company to another. In this regard, consideration should be given to classifying affiliated leasing companies into one experience rating category to correct inter-affiliated transfer abuses.

AUDITEE'S RESPONSE

The auditee responded that our recommendation to pursue recovery of UI Trust Fund losses is unwarranted, that the tax-saving strategies employed by employee leasing companies are not illegal per se, and that there have been no clear cut violations of Georgia successor statute. Furthermore, in their opinion, any effort at litigation would not lead to either criminal conviction or civil victories.

On April 15, 1998, we met with Georgia officials to discuss the "Shell" Employee Leasing Statement of Facts and to determine if legal liability exists. In their written response dated May 19, 1998 (Appendix A), Georgia concurred that a "Shell activity which is defined as transfer of employees to an account with a lower tax rate to circumvent the experience rating provisions of the law can be described as an *abuse of the system, although not necessarily illegal.*" The response went on to say "Criminal prosecutions are unlikely. . . . We believe a more productive approach is to pursue these cases in an *administrative manner.* . . ."

In addition, in their May 19, 1998 letter, Georgia stated:

"Your report may provide an impetus to study the need for changes in the law with respect to successorship and experience rating. . . ."

The auditee further stated:

"Successorship rates obtained by shell employee leasing firms by purchase of defunct non-employee leasing establishments do not violate the literal meaning of OCGA Section 34-8-153. They conflict with our interpretation of Rule 300-2-7-.07, but that Rule appears to be in direct conflict with OCGA 34-8-153, and is therefore probably unenforceable through non-voluntary methods. **This is clearly an area that needs to be studied carefully for future legislative changes.**"

However, its September 18 (Appendix B) response, Georgia stated that "The Department is not the proper party to challenge the intent of the Legislature by unilaterally disallowing the use tax successorship by members of a single industry."

Georgia further stated that there is a distinction between acquiring "substantially all of the business or assets" of an employer versus "acquiring the organization."

Finally, Georgia stated "Upon final review, we feel that the recommendations in the Report that Georgia Department of Labor pursue recovery of UI Trust Fund 'losses' is unwarranted, that the tax-saving strategies employed by employee leasing companies are not illegal per se, and that there have been no clear-cut violations of Georgia's successor statute. . . ."

AUDITOR'S CONCLUSION

The State of Georgia, Department of Labor Employment Security Law, Title 34, Section 34-8-153 (a) Liability of succeeding employer; computation of rate of contributions states, in part:

“Any corporation, partnership, individual, or other legal entity who acquires by purchase, merger, consolidation, or other means substantially all of the business assets of any employer and who thereafter continues the acquired business shall be deemed to be a successor to the employer from whom the business was acquired. The successor shall acquire the experience rating record of the predecessor. . . .” [Emphasis added.]

The acquisition of the successors' tax rates for the four purchased companies that were **not continued** by the employee leasing company after the purchase violated the State of Georgia statute, which specifically prohibits a company from acquiring the UI tax rate of another company if the succeeding company does not continue that acquired business.

The employee leasing companies would have had to continue operating the purchased businesses to statutorily justify the lower UI successorship rates.

While the legality of “shell” activities under Georgia Law is a matter of interpretation, there is no question that such activities are an **abuse** to the experience rating system.

This recommendation is unresolved. We request that ETA address this issue through their formal resolution process.

III. PROCEDURES USED TO IDENTIFY LEASING COMPANIES WERE INEFFECTIVE

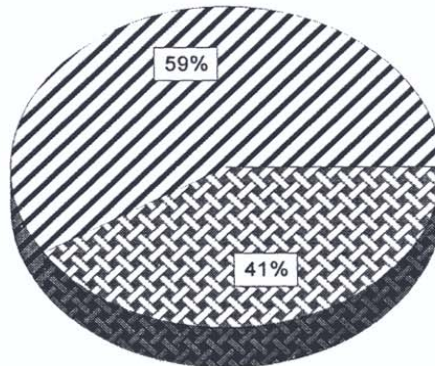
The State of Georgia requires employee leasing companies to post a surety bond if they elect to report leased employees on their payroll. This bonding requirement is designed to ensure the payment of UI tax assessments in event of default. However, Georgia's procedures to identify leasing companies were not effective. Our audit disclosed that approximately half of the leasing companies operating in Georgia had not been identified and we believe it cannot effectively enforce existing surety bond requirements.

The list of leasing companies maintained by Georgia DOL contained 123 leasing companies. However, we identified a total of 232 leasing companies during the course of our fieldwork. Because Georgia had not identified 95 leasing companies (41 percent) operating within the State during our audit period, we believe that it could not effectively enforce existing surety bond requirements.

After identification, we verified the status of these 95 employee leasing companies by written and oral confirmations.

LEASING COMPANY IDENTIFICATION

232 TOTAL EMPLOYEE LEASING COMPANIES



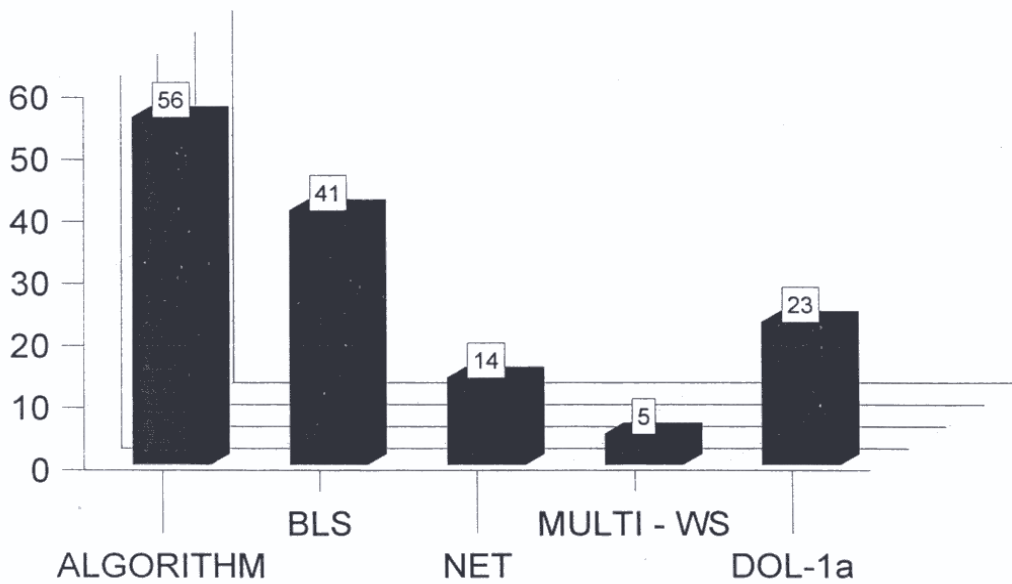
-  Georgia List of Companies - 137
-  Additional Companies Found by OIG - 95

The 95 additional leasing companies were identified using the following various sources:

- BLS listing of employee leasing companies,
- searches for leasing companies via the Internet,
- an ADP algorithm designed to identify such companies,
- Georgia DOL Labor Information Systems (LIS) multiple worksite (WS) reports, and
- Georgia DOL Division of UI employer status reports.

The following graph identifies the sources of the additional leasing companies found in our audit.

**ADDITIONAL 95 EMPLOYEE LEASING COMPANIES *
NOT ON GEORGIA LIST**



*The totals do not add up to 95 because leasing companies were identified by multiple sources and thus in more than one source.

Chapter 300-2-7.07(2) of the Rules of Georgia DOL Employment Security Law states, in part:

“An employee leasing company shall post a surety bond in the amount of the greater of \$10,000 or 2.7% of its taxable payroll for the four (4) calendar quarters immediately preceding the effective date of the bond. . . .”

Section 34-8-172. of the State of Georgia Employment Security Law states in part:

“The Commissioner shall require any employee leasing company . . . to post a surety bond or such equivalent financial securities as approved by the Commissioner in such an amount as needed to cover the total of any potential tax liability which may reasonably be expected to be incurred by such employer. In the event an employee leasing company is unable to procure such bond or security, the employee leasing company may report such employees as being in the employment of its client employers. . . .”

The State of Georgia’s inability to identify or bond employee leasing companies was caused by:

- deficiencies in the format of the employer status report in identifying employee leasing companies,
- inadequate operating procedures to ensure that employer status reports were reviewed for leasing activity, and
- inadequate follow up procedures to ensure employee leasing questionnaires sent by Georgia were answered.

The employer status report, as currently designed, does not specifically ask the employer if it is engaged in employee leasing. In most cases, the Division of Adjudication is unable to determine from the employer status report whether the company is engaged in employee leasing.

As of June 1998, GA DOL, Division of UI, Office of Adjudication had no written procedures to ensure that the employer status reports are adequately reviewed to determine whether a company is engaged in employee leasing. The employer status report is an information return, submitted by the employer, which contains data regarding the nature of the business as well as other information required to determine the employer’s UI tax status. In 23 out of 232 reports reviewed, the employer status reports indicated the firm was engaged in employee leasing activity. However, none of these firms were recorded on Georgia’s list of bonded employee leasing companies.

Periodically, the Division of Adjudication sends questionnaires to employers who they suspect are employee leasing companies to determine their status. However, we found there was no attempt to follow up when employers did not respond to the questionnaires. As a result, no determinations were made for firms who failed to respond.

Employee leasing companies in the State of Georgia are required by statute to post a surety bond if they elect to report leased employees on their payroll. This bonding requirement is designed to ensure the payment of UI tax assessments in event of default. It was not known whether any of the 95 additional employee leasing companies identified in our review posted surety bonds. This inability to adequately identify employee leasing companies places an increased risk on the UI Trust Fund in the event of default.

Georgia UI officials stated that budgetary constraints, including amount of time and resources, impeded the State's ability to adequately identify and monitor the activities of employee leasing companies.

In summary, we believe the estimated 25 percent growth rate in the employee leasing industry and the potential recurring nature of the losses in tax revenue due to abuses to the UI system warrant continued monitoring of the employee leasing industry's impact on the UI Trust Fund.

RECOMMENDATION

Because of the risk of loss to the UI Trust Fund, we recommend that the Assistant Secretary for Employment and Training work with the Commissioner of GA DOL to accomplish the following:

- Revise the employer status report to incorporate a question specifically asking employers if they are engaged in the leasing of employees to other employers (client firms).
- Develop written procedures and ensure that:
 - a. employer status reports are thoroughly reviewed for leasing company identification; and
 - b. questionnaires are sent to suspected leasing companies on a regular basis, companies not responding are contacted, and all responses are properly reviewed and accounted for.

AUDITEE'S RESPONSE

". . . The Department has a direct interest in securing surety bonds from all leasing companies who are utilizing a single unemployment tax rate for reporting purposes, and we therefore concur with the Report recommendations regarding techniques to better identify employee leasing companies in this state, although not for the reasons given by the Report authors. Again, any

employee leasing company reporting under its clients' accounts has no obligation to register with the Department. The Report does not indicate which of the '41%' of the total leasing companies in this state (which were previously unknown to the Department) were reporting under client accounts; to the extent the companies identified were reporting under client accounts, that fact would further invalidate the conclusions drawn by the Report. . . ." Georgia further states that the Bureau of Labor Statistics (BLS) is planning to establish two new industrial classifications in the spring of the year 2000 identifying employee leasing companies which will be facilitated by Georgia without additional effort on the part of Georgia.

AUDITOR'S CONCLUSION

Georgia's procedures to identify leasing companies is ineffective. Without the ability to identify leasing companies, they cannot determine which leasing companies are reporting under client accounts, nor can they determine which leasing companies should be bonded.

With respect to BLS establishing new industrial classifications, this is in the developmental stages and has no effect on Georgia's lack of procedures to identify leasing companies at this time.

This recommendation is unresolved. We request that ETA address this issue through the formal resolution process.

AUDITEE'S GENERAL COMMENTS

The following auditee's general comments are being addressed here, as they do not apply to a specific recommendation in the report.

Auditee's Comment No. 1

The auditee takes exception that OIG's pilot project was terminated after only one state was audited.

Auditor's Conclusion

The objective of our limited scope audit was to determine what effect employee leasing companies had on the UI Trust Fund. Georgia was selected as a pilot state for this limited scope audit. As detailed in Finding I, we found no adverse effect on the UI Trust Fund from bona fide employee leasing operations. Therefore, we did not deem it necessary to pursue this objective any further.

Auditee's Comment No. 2

The auditee questions why such a small industry as employee leasing was selected for audit and why "There is no statement in the Report indicating that other industry members attempted similar transactions to achieve the same results complained of in the Report."

Auditor's Conclusion

As stated in our report, we performed a limited scope audit of the employee leasing industry in the State of Georgia. The audit was undertaken partly as a result of the rapid growth of the leasing industry. Finding II states in part "Abusive shell transactions can occur in industries other than employee leasing; however, we limited our review to the leasing companies identified in our audit." We did not audit other industries and, therefore, are not in a position to comment on whether similar conditions exist in those industries.

Auditee's Comment No. 3

The auditee contends that "fluctuations identified in the Report as "windfall gains" and "losses" are minimal, inconsequential, and immaterial variations in cost to Georgia UI Trust Fund."

Auditor's Conclusion

It is OIG's mission to identify fraud, waste and abuse. While the number of leasing company transactions is small in relation to the Georgia UI Trust Fund, we believe this industry presents an especially high risk of abuse because it is growing at a very rapid pace.

Auditee's Comment No. 4

The auditee contends that while its input was requested, the responses were often ignored.

Auditor's Conclusion

We met with officials from the State of Georgia on a continual basis.

Auditee's Comment No. 5

The auditee contends that "Other industries . . . have far more significant impact . . . remain . . . unaudited. It is difficult to resist an assessment that the OIG study team was predisposed to make certain findings, or to make negative findings, regarding a specific industry. This clearly violates basic audit principles incorporated in the Government Auditing Standards (1994 Revision) cited by the Report authors. Despite its failings, the Report contains worthwhile recommendations. . . ."

Auditor's Conclusion

Government Auditing Standards Chapter 6.3 states in part:

“. . . auditors should define the audit's objectives and the scope and methodology to achieve those objectives. Scope is the boundary of the audit.”

Chapter 7.10 states:

“Auditors should report the audit objectives and the audit scope and methodology.”

Chapter 7.14 states in part:

“In reporting the scope of the audit, auditors should describe the depth and coverage of the work conducted to accomplish the auditor's objectives.”

Page 7 of the report presents the objectives and criteria while page 8 addresses the scope and methodology. This is in compliance with the Government Auditing Standard. The assertion by the auditee that the OIG was “predisposed to make . . . negative findings, regarding a specific industry” is clearly unwarranted and is contradicted by OIG's Report. For example, the heading of Finding I states - THE STATE OF GEORGIA'S UI TRUST FUND BENEFITED FROM BONA FIDE EMPLOYEE LEASING OPERATIONS. Since we did not find significant problems in bona fide operations of employee leasing operations, we decided not to pursue this objective any further. On the one hand the auditee contends that we were “predisposed” against a “specific industry” yet when we decided not to pursue the audit nationally at this time the auditee again had a problem with our decision (see Agency Response 1).

However, we did find abusive and, in our opinion, illegal “shell” activities. While the auditee's response minimizes the disclosure of “shells” in relationship to the overall leasing activities, we consider such practices to be a reportable condition that should be addressed by program management.

Auditee's Comment No. 6

The auditee raises questions about the origin of the definition of the term “shell” transaction and expressed confusion in understanding what the term means. Further, the auditee questions the lack of . . . “counterbalancing losses and gains to the UI Trust Fund. . . .”

Auditor's Conclusion

Since there was no definition for “shell” activity in any of the UI literature, we defined the term (with discussion and input from ETA) for the purpose of our audit. We also discussed the definition with Georgia UI and solicited their comments. On April 15, 1998, we met with Georgia officials to discuss the “Shell” Employee Leasing Statement of Facts and to solicit their

comments. On May 19, 1998, we received a written response from the auditee (see Appendix A) that stated in part:

“Shell activity which is defined as transfer of employees to an account with a lower tax rate to circumvent the experience rating provisions of the law can be described as an abuse of the system. . . . In conclusion, we believe the factual matters you presented are accurate. . . .”

Regarding the counterbalancing of gains and losses for “shell” activity, Finding II page 12 addresses this point and finds the windfall profit to be immaterial.

Auditee’s Comment No. 7

The auditee questions the projection of losses beyond the 5-year audit report period and the lack of gains to offset the losses.

Auditor’s Conclusion

Government Audit Standards Chapter 6.35 states in part:

“When information comes to the auditors’ attention . . . indicating that abuse may have occurred . . . the auditors should extend the audit steps . . . to determine its effect on the audit results.”

Since abusive and, in our opinion, illegal “shell” activities were found in our audit period, we made the necessary calculations to determine the impact of the abuse through the most recent time that Georgia records were available during our audit fieldwork.

APPENDIX A

AUDITEE'S RESPONSE TO

STATEMENT OF FACTS



GEORGIA DEPARTMENT OF LABOR

148 INTERNATIONAL BLVD., N.E. ♦ ATLANTA, GEORGIA 30303-1751

MARTI FULLERTON
COMMISSIONER

May 19, 1998

Mr. William Kish
Assistant Regional Inspector General for Audit
U.S. Department of Labor - Office of Inspector General
3535 Market Street, Room 12100
Philadelphia, Pennsylvania 19104

Dear Mr. Kish:

Thank you for the opportunity to comment on the portion of your draft report which covers possible abuses by employee leasing firms of the experience rating provisions of the Employment Security Law. We look forward to receiving the entire draft report of your findings on the employee leasing industry.

After careful review of your initial findings, tempered by our recent meeting on this subject, it is our conclusion that three (3) of the cases cited (Shell Worksheet numbers III, V and VI) represent probable abuses of the intent, if not the literal letter, of the law. The other three (3) cases (Shell Worksheet numbers I, II and IV), however, are legal within the meaning of the current law and regulations of Georgia, as more fully described below, and in our opinion should not be included in your report as potential cases of abuse of the law. For purposes of simplicity, the Employment Security Law of Georgia (OCGA Section 34-8-1 et seq.) will be cited as "the law", and the Official Rules of the Georgia Department of Labor (300-2-1 et seq.) will be cited as "the rules".

In each of the cases described in Shell Worksheets I, II and IV, the transactions do not violate the law or rules. Each case may well reflect an intent to acquire lower unemployment tax contribution rates and thereby lower taxes, but that is not per se illegal. Your report may provide an impetus to study the need for changes in the law with respect to successorship and experience rating, but does not appear to provide the basis for civil or criminal action against the employing units which were involved. Further, the definition of a "Shell Transaction" developed by the Office of the Inspector General, while helpful for purposes of analysis, does not necessarily mean a particular transaction or group of related transactions which meets that definition is illegal. For example, the fourth element in the definition relies on the representation there is "no documented or apparent business

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reason for the purchase or reorganization between affiliated companies other than to achieve lower employment costs, including UI taxes." This assumes there are no reasons for the transfer which you discussed, but there are many reasons to create new entities. Typical reasons for starting a new corporation, for example, are to limit civil liability; to raise new capital; for accounting or tax purposes (e.g., Sub-S Corporation vs. Standard Corporation, which are taxed differently); for ease or convenience of operations in multiple states, and changes in ownership and/or management. These are just some of the more obvious reasons. Whether any of these conditions, or other factors which could explain a change in legal entity, actually occurred in the cases described in Shell Worksheets I, II and III cannot be determined from the work papers. The definition of a "shell transaction" also belies the right of corporations or other entities to create new entities which are affiliated, even if the primary purpose is to lower tax liability. These corporations may have identified weaknesses in the law or rules which they used to their advantage, but there is no evidence of criminal activity. Any action we take on these accounts will be administrative, i.e., we will consider notification to the employers that tax rates/experience rating have been adjusted. This necessarily will include appeal rights. Since the transactions appear to be legal under the law, however, the employer's justification for a change in entity appears to be irrelevant.

More specifically, in the case described in Shell Worksheet I, the transfers are between affiliated entities with elements of common ownership and management. Non-related businesses were not purchased for the purpose of acquiring a lower rate, as contrasted with what apparently occurred in Shell Worksheets III, V and VI. At least one of the corporations involved, _____, Inc., DOL Account No. _____, was an out of state corporation. The other two corporations were both domestic corporations in existence prior to the transfers of employees, which infers reasons for the creations other than simply lowering unemployment contribution rates were present.

This case appears to involve routine transfers. The transfer from _____ Inc., DOL No. _____, to _____ Inc., DOL number _____ was correctly deemed by this department to be a successorship, and actual experience and unemployment tax rates were merged as provided under the law. This includes most of the tax and benefit experience of the three (3) separate accounts. The transfer from _____ Inc., DOL No. _____ to _____ was not deemed a successor because it was a stock purchase. Further, future rates for this employer will likely rise as an adjustment to the increase of payroll, which will tend to lessen the impact of the transfer on tax rates.

William Kish
Page Three

The situation described in Shell Worksheet II is not a loss to the trust fund because the transfer was expressly permitted by law. The first portion of the transfer was between affiliates with the same tax rate, therefore no loss occurred, as explained in your draft. The second transfer was expressly permitted by a change to OCGA Section 34-8-153(b), which was amended effective July 1, 1995. This change allows a business to purchase another business with a higher tax rate without inheriting the adverse experience underlying the higher tax rate. The legislative intent behind this change in the law specifically addressed a situation such as this. While we can agree or disagree with the legislature's wisdom on this point, it was within their discretion to pass this change in the law to encourage the sale of struggling businesses which have earned a higher tax rate. The change in the law was viewed by our legislature as an economic incentive to encourage employers to do business in Georgia.

Although at first glance the data contained in Shell Worksheet Number IV suggests shell activity occurred, our examination revealed that the explanation for two of the transfers was due to actions of the department, rather than the employer. For example, the majority of the loss calculated on this transaction in the OIG draft report was caused by the transfer of employees from DOL account number [redacted] to DOL account number [redacted]. This transfer was actually the result of an internal adjustment by this department and not due to any overt action taken by the employer. We had established duplicate accounts and required separate employee leasing surety bonds on each account. The first account [redacted] was set up in June of 1988 as [redacted] Inc. [redacted] Inc. notified the department it had purchased the entirety of the business in October, 1992. This was a stock purchase only, and the business continued to operate under the name of [redacted] Inc. A form DOL-1 was received in March 1993 showing this transfer. A successorship determination was made in our records, effective November 6, 1993. Before the successorship determination was made, however, a cash deposit of \$10,000.00 for the new account was submitted. Since an account had not yet been established, a temporary or "dummy" account and number were assigned to process the cash deposit payment. The account was set up effective January 11, 1994, based upon records of the Secretary of State. As no successorship decision had been made, we did not realize there were duplicate accounts.

When we discovered there were duplicate accounts, the liability date was changed from January 11, 1994 to November 6, 1993. The previous account was voided and combined with the successor account. Quarterly tax reports submitted under account number [redacted] for the fourth quarter of 1993 through the first quarter of 1995 were transferred to account [redacted]. The extra cash

William Kish
Page Four

deposit of \$10,000.00 was refunded in June of 1995 when the "dummy" account was inactivated. None of this was due to activity by the employer, and the correct amount of tax was paid by the employer. All reports that were moved to account number were moved back to the accounts under which they were originally processed and charged at the correct rates for those accounts. The transfer of the 60 employees from account number to account number appears to meet the OIG definition of shell transfer and should be included in your report. With this one exception, there were no trust fund losses resulting from the movement of these reports.

The answers to the inquiries directed to Mr. Walt Adams, our Chief of U.I. Legal Section, in the order requested, are as follows:

1. Successorship rates obtained by shell employee leasing firms by purchase of defunct non-employee leasing establishments do not violate the literal meaning of OCGA Section 34-8-153. They conflict with our interpretation of Rule 300-2-7-.07, but that Rule appears to be in direct conflict with OCGA Section 34-8-153, and is therefore probably unenforceable through non-voluntary methods. This is clearly an area that needs to be studied carefully for future legislative change.
2. Employee transfers between affiliated entities are not expressly addressed in the law or rules.
3. Rule 300-2-7-.07 was intended to prevent leasing entities from transferring employees between different accounts, but the wording is probably not tight enough to prevent such transfers.
4. Shell activity which is defined as transfer of employees to an account with a lower tax rate to circumvent the experience rating provisions of the law can be described as an abuse of the system, although not necessarily illegal.
5. Criminal prosecutions are unlikely, as a clear intent to violate the law would be extremely difficult to prove. Our experience in previous criminal actions against employers or unemployment insurance claimants is prosecutors are reluctant to pursue an alleged crime unless it is easily provable and can be easily understood by a jury as a crime. We believe a more productive approach is to pursue these cases in an administrative manner, with formal notice of tax rate changes and appeal rights granted. This allows the affected employers an opportunity to attempt to explain if legitimate business reasons for the transfers existed.

William Kish
Page Five

In conclusion, we believe the factual matters you presented are accurate, but only three of the cases (plus \$6,120.00 of Shell Worksheet IV) should be included in your report, as more fully explained, supra.

For the reasons stated above, it is our opinion these three (3) cases should not be included in your write-up as trust fund losses.

We appreciate the time and effort you and your staff put into the audit and look forward to your draft report.

Sincerely,



Robert E. Thomas
Chief of Tax Administration
Suite 800
(404) 656-4309

RET/WNA:rdh

APPENDIX B

**AUDITEE'S RESPONSE TO
DRAFT REPORT**



GEORGIA DEPARTMENT OF LABOR

148 INTERNATIONAL BLVD., N.E. ♦ ATLANTA, GEORGIA 30303-1751

MARTI FULLERTON
COMMISSIONER

September 18, 1998

FAX and REGULAR MAIL

Mr. Roger B. Langsdale
Regional Inspector General for Audit
U. S. Department of Labor - Office of Inspector General
3535 Market Street, Room 12100
Philadelphia, Pennsylvania 19104

RE: Georgia Department of Labor Response to Report #03-98-007-
03-315, Effect of Employee Leasing on the State of Georgia
Unemployment Trust Fund - Draft Report, Issued: 8/20/98

Dear Mr. Langsdale:

Enclosed is the Georgia Department of Labor response to the
above-identified Draft Report on the Employee Leasing
Industry. It is our understanding that this response will
be an addendum to your office's final report, when issued.

Thank you for the extension of time necessary to comment on
the audit work and Draft Report.

Sincerely,

Walter N. Adams
by Brock P. Jones

Walter N. Adams
Assistant Commissioner
for Unemployment Insurance
(404) 656-3050

WNA:bct

9/18/98

GEORGIA DEPARTMENT OF LABOR

Response to

The U. S. Department of Labor, Office of Inspector General

Draft Report on the

EFFECT OF

EMPLOYEE LEASING ON THE STATE OF GEORGIA UNEMPLOYMENT

TRUST FUND

**Report Number: 03-98-007-03-315
[Issue Date: August 20, 1998]**

GDOL Issue Date: September 18, 1998

GEORGIA DEPARTMENT OF LABOR
RESPONSE TO
The U. S. Department of Labor, Office of Inspector General
Draft Report on the EFFECT OF
EMPLOYEE LEASING ON THE STATE OF GEORGIA UNEMPLOYMENT
TRUST FUND
Report Number: 03-98-007-03-315
[Issue Date: August 20, 1998]

GDOL Issue Date: September 18, 1998

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INTRODUCTION

This filing is submitted in response to the Office of Inspector General [OIG] Draft Report on the EFFECT OF EMPLOYEE LEASING ON THE STATE OF GEORGIA UNEMPLOYMENT TRUST FUND, Report Number: 03-98-007-03-315, issued August 20, 1998, (the "Report") and on the various findings in the Report. Our comments encompass matters of fairness, tone, and accuracy of the report, the purpose, attitude, and goals of the study team, and the veracity and value of the findings in the Report. We recommend review and revision of the Report in accordance with the information contained here.

At the outset, we express concern that the focus of the initial project, originally proposed to the Georgia Department of Labor (hereinafter the "Department" or "GDOL") as a five state pilot study on the effect of the employee leasing company industry on the UI Trust Fund, with Georgia's agreement to be the first state studied, has developed, upon the unilateral decision and action of the Office of Inspector General's office, into a full-blown audit of the employee leasing industry in Georgia only. Even as recently as June, 1998, GDOL was assured that the Report would be issued as a "Management Report."

The Report studies those employee leasing companies which, during the audit period, secured favorable unemployment tax rates through the use of affiliated companies and targeted "shell" acquisitions. According to the audit report findings, as of the time of audit, the employee leasing industry¹ in Georgia was composed of 232 companies,

¹ Employee leasing companies provide employer services to small to medium-sized businesses. An employee leasing arrangement shifts employees from existing employee populations to the employee population of the employee leasing company, which, during the term of the arrangement, becomes the

representing 0.13% (slightly more than 1/10th of one percent) of all active employers in this State. This is a small industry sector from which the Report selects four firms and extracts and scrutinizes their transactional records. There is no statement in the Report indicating that other industry members attempted similar transactions to achieve the same results complained of in the Report.

The employee leasing industry is growing at a rate of up to 30% per year "...fueled by increases in employee benefit costs, particularly health insurance and workers' compensation premiums, both of which represent a larger share of the nonwage labor cost than UI."² A number of other states, including Alaska, California, Colorado, Nevada, Rhode Island, and Tennessee, prohibit the transfer of unemployment tax rate experience. Georgia, however, has had a statute in place allowing for UI account successorship, upon increasingly more and more favorable terms, for over fifty years. Under such circumstances, Georgia would be a good place to examine successorship generally, since the occurrence of successorship events would clearly be expected to be found in the audit of any industry having large numbers of Georgia employees or which normally utilizes state and local taxation consulting services. It is certainly no surprise to find that employee leasing companies, with extremely high numbers of employees, have utilized successorship laws to their tax benefit, where applicable.

"employer of record" or "statutory employer" and commences reporting the shifted employees on the employee leasing company's tax account(s). Generally, the contract between the employee leasing company and its client companies states that the leasing company and its client become "co-employers" of the employees who are covered by the arrangement; significantly, whether or not stated in writing, employer responsibilities are divided between the parties either in fact or under current law. See O.C.G.A. Section 34-8-32, 34-8-170, 34-9-11[c]; Internal Revenue Code Section 414(n).

² Employee Leasing: Implications for State Unemployment Insurance Programs, a report delivered to all State Employment Security Agencies under Directive: Unemployment Insurance Program Letter No. 32-97.

Because rapid employee-population growth in the employee leasing industry is normal and the majority of such growth is lateral³, it is both reasonable and prudent to examine the potential impact on the Georgia Unemployment Insurance Trust Fund (UI Trust Fund), from employee leasing company industry practices. This includes, specifically, any impact on the state unemployment tax experience rating system. Similarly, it is also reasonable to expect any employer with significant, rapidly growing unemployment tax liabilities to seek the most tax favorable status available under the law.

It is the position of the Department that the fluctuations identified in the Report as “windfall gains” and “losses” are minimal, inconsequential, and immaterial variations in cost to the Georgia UI Trust Fund. The Report’s emphasis on taking a separate look at the “windfall gains” and “losses” supports this position, since an offset of gains and losses demonstrates the relatively minor nature of the net impact of employee leasing company successorship transactions on the Georgia UI Trust Fund. Additionally, as will be discussed later in the section entitled “Alleged ‘Shell’ Transactions by Employee Leasing Companies,” the windfall gains and losses to the UI Trust Fund are not accurately reported. Furthermore, although GDOL input was specifically requested during the audit process, our responses were often ignored, even with regard to interpretations of Georgia law and rules. Consequently, we repeat here much of the information previously brought to the attention of the Report authors, with full citation and quotation of pertinent authority.

³ The word “lateral” is used here to describe the shifting of existing employees of one or more employers from and to the employee population of another existing employer, the employee leasing company, which consolidates quarterly reports and tax payments on its growing employee base.

Other industries, such as the construction and textile industries, have a far more significant impact on the Georgia UI Trust Fund than employee leasing companies, yet those other industries remain unstudied, unreported, and unaudited. It is difficult to resist an assessment that the OIG study team was predisposed to make certain findings, or to make negative findings, regarding a specific industry. This clearly violates basic audit principles incorporated in the Government Auditing Standards (1994 Revision) cited by the Report authors.

Despite its failings, the Report contains worthwhile recommendations, and these are recognized whenever possible. Every effort will be made to incorporate all useful recommendations into future action by the Georgia Department of Labor, subject to limitations noted here.

The Employee Leasing Industry and Unemployment Insurance

Defined under Georgia law at O.C.G.A. Section 34-8-32,⁴ employee leasing companies, also known as Professional Employer Organizations or PEOs, are companies that provide employer services to other small to medium-sized businesses and are Employee leasing companies establish unemployment tax experience rating just like any other employer in this state, i.e., after an initial 3 year period during which time reserves are accumulated at a fixed "new employer rate," currently 2.7%. Since 1991, all employee leasing companies in Georgia have been required to report wage information and pay unemployment taxes in one of two ways: (1) in the name and account of the leasing company, upon the filing of a statutorily-required security deposit, or (2) in the name and account of each client, which entails administering, reporting, and making payment of each client's UI tax responsibilities separately, one report and payment quarterly for each and every client. Leasing companies in the latter category #2 have

⁴ O.C.G.A. 34-8-32: (a) As used in this chapter, the term "employee leasing company" means an independently established business entity which engages in the business of providing leased employees to any other employing unit under the following conditions:

- (1) Negotiates with clients or customers for such matters as time, place, type of work, working conditions, quality, and price of service;
- (2) Determines assignments of individuals to its clients or customers, even if the individuals retain the right to refuse specific assignments;
- (3) Sets the rate of pay of the individuals, whether or not through negotiation;
- (4) Pays the individuals from its accounts; and
- (5) Hires and terminates individuals who perform services for the clients or customers.

(b) Individuals performing services for an employee leasing company shall be considered employees of the employee leasing company. The employee leasing company shall file required reports in accordance with regulations prescribed by the Commissioner and pay contributions on wages paid to such employees.

(c) Individuals who perform services for temporary help contracting firms as that term is defined in Code Section 34-8-46 shall not be considered employees of an employee leasing company.

merely taken on an administrative task that should have no impact on the compiled experience for any taxpayer, whereas leasing companies in the former category #1, that make consolidated reports under their own tax experience rate, could conceivably impact the application of tax experience ratings to payroll. Employee leasing companies in this category #1 are the subject of the Report.

Employee leasing companies that consolidate all client workers into a single report can impact the UI Trust fund, if the employee leasing company experience rate applied to its taxable wage base results in less tax than the sum total of each of its clients' tax experience rate applied to that client's taxable wage base. But when employees are shifted (by contract or other mechanism) from a client company to a leasing company, the impact on the UI Trust Fund is not always negative (i.e., does not always create a "loss"); the impact may be negative, neutral, or positive. Also, whatever the initial impact, the eventual impact over a period of years will vary in character, as well, depending on the tax rates of each client company, the tax rate of the employee leasing company, the number of employees transferred in each employee leasing arrangement, at what time during the year the employees are transferred, subsequent claims and claims management by the leasing company (as compared to similar efforts by the client companies), and market eventualities such as business cycles and fluctuating UI Trust Fund reserves. The impact of an employee leasing arrangement can be positive under the following conditions:

1. The employee leasing company has a higher tax rate than the subscribing client company, either because the leasing company is a new employer under the unemployment law with the standard "new

employer rate" of 2.7% and the client company is at a lower experienced base rate or because the leasing company has a higher experience tax rate than the client company.

2. Duplicate UI taxes are paid for the same employees by the employee leasing company and the client company in the year of transfer to the employee leasing arrangement.
3. Rapid growth of an employee leasing company's average payroll under the standard Georgia experience rating calculation can and does cause a steep rise in the annual experience tax rate issued to the leasing company in subsequent years. This will raise dollar contributions to the UI Fund for years into the future until adequate reserves are established under the standard experience rating formula to fund potential claims.
4. A reimbursable employer, which would normally make no contribution to or have any impact on the UI Trust Fund, may engage the services of an employee leasing company, thereby causing new tax payments to be generated, and these new taxes are gains to the UI trust Fund and may exceed claims.
5. Certain small employers, not previously subject to the unemployment tax law, may be made subject to the law via an employee leasing company service arrangement; for example, a small partnership of professionals with no staff personnel could engage a leasing company and precipitate payment of new taxes for the partners as employee

leasing company employees; whereas no tax was being paid previously, the entirety of the new tax contribution made by the employee leasing is a gain to the UI Trust Fund.

AND

6. Previously delinquent employers, non-complying employers, and independent contractors can become clients of employee leasing companies in their effort to transition into compliance or to obtain the non-UI related benefits of a leasing arrangement. One employee leasing company in Georgia, upon our inquiry, reports that since its inception in 1995, 39% of its clients fall into this category. This adds additional funds to the UI Trust Fund.

Except for items #1 and 2, the Report fails to recognize any of the other positive factors listed above, some of which are substantial in impact, particularly #3, in making its findings on the effect of employee leasing on the Georgia UI Trust Fund.

Alleged "Shell" Transactions by Employee Leasing Companies

Employee leasing companies consider unemployment tax rate charges to be one of the costs of providing services to their clients, similar to health insurance premium costs, workers compensation insurance costs, and other operational costs. Consequently, unemployment tax rate "costs" receive management attention in both strategic planning and operations. In addition to "managing" unemployment accounts as traditional tax

bureaus (R. E. Harrington, Frick, Gates-McDonald, and others) have done in the past⁴, some employee leasing companies have utilized affiliated companies and tax rate successorship laws to achieve improved experience rates. The Report focuses critical attention on the activities of four (4) employee leasing companies that allegedly have, in some form, utilized either (1) affiliated company relationships or (2) Georgia unemployment tax successorship laws, or both, to accomplish improper tax savings, to the detriment of the Georgia UI Trust Fund.

The Report on Page 1 designates a three-part objective to:

1. identify the universe of employee leasing companies operating within the State during a 5-year period,
2. determine whether "shell" leasing company activities existed, and
3. determine what impact employee leasing company operations and "shell" leasing company activities had on Georgia's UI Trust fund.

The Report's definition of "Leasing Company 'shell' Activities" on Page 7 is as follows:

"Shell" leasing activity occurs when (1) an employee leasing company transfers all or a major portion of its employees to a relatively inactive or dormant company which is owned or purchased by the leasing company to obtain lower UI tax rates; (2) a significant percentage (20 percent or more) of employees are transferred from one employer to another with common ownership and control; and (3) losses to the UI Trust fund occur because the successor company had a lower UI tax rate than the predecessor.

At the time the pilot study-turned-audit was proposed, we were unfamiliar with any statutory or other legal definition of "shell" transaction, and since initiation of the pilot-audit, we have been unable to identify any such definition. During the process of the audit examination, the working definition declared by OIG was revised no less than three

⁴ Traditional bureau services include the monitoring of employee dismissals/terminations, review of UI tax account charges, and active participation in both the initial determination and appeal stages of UI claims to effectively manage experience tax rates.

times, making it difficult, if not impossible, to properly identify any company that fit the definition.

In its final form, the definition of "Leasing Company 'shell' Activities" abandons the concept of counterbalancing losses and gains to the UI Trust Fund and focuses only on "losses", thereby frustrating the objective #3 above, which clearly looks to the net impact on the UI Trust fund, not just the "losses" factor. Although the Report does face the issues of counterbalancing gains to the UI Trust Fund initially, it only does so separately (prior to identifying any "losses"), and this corrupts the ability to evaluate the net impact on the UI Trust Fund.

The Report fails to take into account that the unemployment tax system is based on insurance principles, and events like a shift in employee population from one employer to another, the development or occurrence of a low employer reserve, or excessive unemployment claims on an account will stimulate a protective reaction. A fluctuation in employee population and payroll will by necessity trigger a change in tax rate in future periods. For example, the Report tabulates windfall gains to the UI Fund from:

1. Duplicated UI taxes paid for employees who were employed by an employer who, after commencing unemployment tax payment during a calendar year, engaged the services of an employee leasing company which repeated partial or full year tax payment for the same individuals, working at the same job and worksite; and

2. Higher rate UI taxes paid for employees by a leasing company with a higher UI tax rate than one or more of its clients, but only in the year of transfer.

The Report does not, however, take into account other sources of gains to the UI Fund. One such source, pointed out earlier in this response, is the total additional dollar contribution to the UI trust Fund generated by any succeeding year tax rate increases which will be incurred by a leasing company and paid to the UI Fund when reserves are calculated to be inadequate to cover potential claims. More specifically, the Report reaches forward into 1997, the year after the 5-year audit report period, to report additional "losses" of \$651,988 but does not report the additional dollar gains to the UI Fund collected in 1997 and following years which are a direct, formula-certain result of rapid payroll growth caused by sharply increased tax rates.

The Report, in its Chart of Losses to the State UTTF By Purchased "Shells", lists losses for "Shell" # IV at \$816,131.00, more than twice the amount determined in the audit findings under Trust Fund Loss Calculations, where the audit states:

Total Shell No. 4 Loss	\$405,173.00
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In the case of an alleged "shell" firm (Shell No. V), the Report authors chose to ignore that the firm with a low UI tax rate (which was the surviving firm in a corporate merger) purchased the employee leasing company, not the other way around. Furthermore, prior key personnel of the firm which was identified by the Report authors as dormant, were paid wages for at least one year after the merger. In that case, regardless of the party that the Report authors identify as the successor or predecessor, the transaction itself satisfies the law on tax rate successorship. It is difficult, if not impossible, to impartially adjudge

the positive or negative impact of the employee leasing industry on the Georgia UI Trust Fund (the stated objective of the report), within the framework of such a target-minded assessment and report.

Affiliated & Successor Firms

In the material that follows, we use the term “shell” transaction to be consistent with the language of the report. It appears that the employee leasing company activity complained of in the Report can be more accurately identified as the utilization of successive or replacement experience ratings with affiliated or business-dormant companies. Presumably, the word “shell” is helpful to the Report authors to isolate such transactions, although we note that similar such tax-strategic transactions occur frequently in the business world.

Affiliated Companies

Georgia law clearly recognizes the legal separateness of individuals, partnerships, corporations, and other statutory entities. To allude otherwise, by use of the phrase “‘shell’ transaction,” flies in the face of settled matters of corporate law. A “corporation” is a legal entity, distinguished from any or all of its stockholders. That one person may own a majority or all of the stock of the corporation does not establish an identity between him and the corporation, so as to make acts by him in his individual name its acts. Garmany v. Lawton, 124 Ga. 876 (1905). A “corporation” is in law an entity entirely distinct from its stockholders and officers, and it may have interests

distinct from theirs. J.J. McCaskill Co. v. U.S., 216 U.S. 504. A “corporation” is an artificial being, invisible, intangible, and existing only in contemplation of law. Adams v. Georgia Railway & Electric Co., 142 Ga. 497 (1914). It is created by law for specific purposes, the limits of whose existence, powers, and liabilities is fixed by its charter. Venable Bros. v. Southern Granite Co., 135 Ga. 508 (1910). The fact that two corporations are incorporated by the same people and have the same officers and are utilized to serve the ends of one of the corporations does not show identity of the two as one corporation. Trans-American Communication, Inc. v. Nolle, 134 Ga. App. 457 (1975).

Georgia law clearly empowers corporations in this state with all the powers reasonable and necessary to transact the designated “shell” transaction activities of which the Report complains.⁵ Note also the provisions of O.C.G.A. Section 34-8-154 requiring

⁵ 14-2-301. Every corporation incorporated under this chapter has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation.

14-2-302. Unless its articles of incorporation provide otherwise, every corporation has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs, including without limitation power:

- (4) To purchase, receive, lease, or otherwise acquire, own, hold, improve, use, and otherwise deal with real or personal property or any legal or equitable interest in property, wherever located;
- (5) To sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of all or any part of its property;
- (6) To purchase, receive, subscribe for, or otherwise acquire, own, hold, vote, use, sell, mortgage, lend, pledge, or otherwise dispose of, and deal in and with shares or other interests in, or obligations of, any other entity;
- (7) To make contracts and guarantees, incur liabilities...
- (9) To be a promoter, partner, member, associate, or manager of any partnership, joint venture, trust, or other entity;
- (10) To conduct its business, locate offices, and exercise the powers granted by this chapter within or without this state;
- (12) To pay pensions and establish pension plans, pension trusts, profit sharing plans, share bonus plans, share option plans, and benefit or incentive plans for any or all of its current or former directors, officers, employees, and agents;
- (14) To transact any lawful business that will aid governmental policy;
- (15) To provide insurance for its benefit on the life or physical or mental ability of any of its directors, officers, or employees or any other person whose death or physical or mental disability might cause financial loss to the corporation: and for these purposes the corporation is deemed to have an insurable interest in such persons; and

the Commissioner of Labor to maintain a separate account for each employer and to credit such account with all the contributions paid by that employer; this applies to all employers, regardless of ownership.

The ownership and transfer of affiliated corporations by employee leasing companies is neither improper nor abusive in and of itself. Designating a business entity as a "shell" does not legally make it something improper. The findings of the Report ignore that the actions alleged to have been taken by employee leasing companies may be and are taken frequently by other firms and companies on the advice of tax consulting firms. In addition, the Internal Revenue Service has ruled that employees can be an asset of the company and, as such, may be purchased (Rev. Ruling 72-269).

Successorship

Since 1943, when the original Georgia Unemployment Act of 1937, was amended, Georgia has had a statute covering the tax liability and tax rate of succeeding employers, which is currently embodied in O.C.G.A. Section 34-8-153⁶. In a

(16) To make payments or donations or do any other act not inconsistent with law that furthers the business and affairs of the corporation.

14-2-304. (a) Except as provided in subsection (b) of this Code section, the validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act.

(b) A corporation's power to act may be challenged:

- (1) In a proceeding by a shareholder against the corporation to enjoin the act;
- (2) In a proceeding by the corporation, directly, derivatively, or through a receiver, trustee, or other legal representative, against an incumbent or former director, officer, employee, or agent of the corporation; or
- (3) In a proceeding by the Attorney General under Code Section 14-2-1430.

(c) In a shareholder's proceeding under paragraph (1) of subsection (b) of this Code section to enjoin an unauthorized corporate act, the court may enjoin or set aside the act, if equitable and if all affected persons are parties to the proceeding, and may award damages for loss, other than anticipated profits, suffered by the corporation or another party because of enjoining the unauthorized act.

⁶ O.C.G.A. 34-8-153: (a) Any corporation, partnership, individual, or other legal entity who acquires by purchase, merger, consolidation, or other means substantially all of the business or assets of any employer and who thereafter continues the acquired business shall be deemed to be a successor to the employer from

case decided prior to passage of the State's first successorship statute, Schwob Manufacturing Company v. Huiet, 69 Ga. 285 (1943), Georgia's highest Court declared that the tax rate experience of an individual could not be transferred to a corporation which continues the individual's business, even if the individual owns most or all of the stock in the corporation. In Phillips v. J.L. Peed Company, 78 Ga. App. 471 (1949), after passage of the successor law amendment, the Court of Appeals ruled Schwob

whom the business was acquired. The successor shall acquire the experience rating record of the predecessor except as otherwise provided in this Code section. If the successor is not already an employer at the time of the acquisition, the rate of contributions applicable to the predecessor shall continue to be applicable to the successor; provided, however, if the existing rate of contributions of the predecessor exceeds the new employer rate as specified in Code Section 34-8-151, the successor shall be assigned a new employer rate of contributions; in such event, the experience of the predecessor shall not be considered for purposes of rate calculations and the successor shall be otherwise treated as a new employer.

(b) If the successor is already an employer at the time of the acquisition, the rate of contributions applicable to the successor shall continue until the end of the quarter in which the acquisition occurred. The rate of contributions applicable to the successor beginning on the first day of the quarter following the acquisition will be determined by the combined experience of the predecessor and successor as of the applicable computation date; provided, however, the experience of the predecessor shall not be combined with that of the successor for purposes of rate calculation if the predecessor's rate of contributions immediately preceding the acquisition exceeded the rate already in effect for the successor; in such event, the experience of the predecessor shall not be considered for purposes of rate calculations unless this combination of experience results in a reduction of rates.

(c) Any employing unit which acquires by any means any clearly identifiable or separable portion of the business of an employer and is an employer at the time of the acquisition or becomes an employer within six months from the end of the quarter in which the acquisition is made may be deemed to be a partial successor to the employer from whom the portion of the business was acquired. A portion of the predecessor's experience rating records which are attributable to the portion of the business which was acquired may be transferred to the successor. Mutual consent of both parties must be given to effectuate the partial transfer. The Commissioner shall prescribe by regulation the time frame for notification to the department of partial acquisitions and the method by which the portion of the experience rating record to be transferred will be determined.

(d) If the conditions of subsection (c) of this Code section are met and the partial successor is not already an employer at the time of the acquisition, the rate of contributions applicable to the predecessor shall be applicable to the successor. Future rates will be determined by combining the transferred portion of the predecessor's experience rating record with the successor's own experience rating record as of the applicable computation date.

(e) If the conditions of subsection (c) of this Code section are met and the partial successor is already an employer at the time of the acquisition, the rate of contributions applicable to the successor shall continue until the end of the quarter in which the acquisition occurred. The rate of contributions applicable to the successor beginning on the first day of the quarter following the acquisition will be determined by combining the transferred portion of the predecessor's experience rating record with the successor's own experience rating record as of the applicable computation date.

(f) Nothing in this Code section shall be construed to affect liens which are created pursuant to Code Section 34-8-167.

inapplicable to the case of an individual who transferred his business to a partnership (of which he was a partner) and relied on the successor statute to enforce the partnership's right to the prior individual's unemployment rate, even retroactively to the effective date of the successor amendment. This statement and interpretation of the law in Georgia stands today, only further enhanced by the 1991, 1995, and 1997 amendments to O.C.G.A. Section 34-8-153. Note that the successor and predecessor firms (as identified in O.C.G.A. Section 34-8-153) in Phillips are related parties.

There are four ways to obtain a tax experience rating: (1) As a new employer, (2) by earning a rate over time, (3) as a successor employer, or (4) as a partial successor employer. Other than as a new employer or an employer with an earned rate, unemployment tax rates are commonly obtained in some form of business acquisition or merger under methods (3) and (4).

Businesses acquire other businesses with critical attention to multiple tax issues. There are two broad groups of acquisition transaction: (1) taxable transactions (sale of stock or assets for cash or other property) and (2) tax deferred transactions (generally, mergers, consolidations, some sales of stock or assets). The two issues that are most likely to dictate the particular form of a given business purchase or sale are (1) liability issues and (2) tax considerations. An acquiring corporation may acquire its intended target either directly or through a subsidiary. A subsidiary may be used for one or more of the following purposes: (1) to insulate the acquiring corporation from liabilities of the target company; (2) to operate the acquired company as a separate entity for purposes of administration; (3) to facilitate a subsequent sale; (4) to obtain separate financing for the acquisition; (5) in order to offer shareholders of the target company shares in the acquired entity rather than shares in the acquiring corporation. Successor liability can be imposed upon a corporate buyer ... There has been a tendency in recent years on the part of some courts to impose successor liability on an entity acquiring all or a portion of the assets of a business under certain circumstances. This is particularly true where the business continues to operate in substantially the same form, using the same name, as it did prior to the sale. A purchaser will wish to check the

case law regarding successor liability in the applicable jurisdiction and discuss with legal counsel the ways in which such successor liability may be minimized.

A second general way of structuring an acquisition is through the purchase of stock of the target company in exchange for cash and/or notes from the acquiring entity or in exchange for stock of the purchaser or a subsidiary of the purchaser. In a stock acquisition, there is no need to identify specific assets for purposes of transfer; all of the assets and all of the liabilities, both known and unknown, are transferred to the purchaser by virtue of the transfer of stock of the target to the purchaser.

The last basic structural alternative (discussed here) is a statutory merger. In a merger, two corporations or other business entities are merged into one entity which survives the merger and succeeds to all of the assets and liabilities of both of the merging corporations.⁷

In reviewing the statutory requirements of O.C.G.A. Section 34-8-153, which covers the liability of succeeding employers and computation of rates of contributions, it is clear that successorship is allowed, particularly after the amendments effective July 1, 1995. Since enactment of the 1995 amendments, it is possible for a purchasing (successor) company to "succeed to" the lower of either (1) its own account rate, if lower than the target company's (predecessor's) rate, (2) a new employer rate, if the successor is not an employer at the time of purchase and the new employer rate is lower than the target company's rate, or (3) the target company's rate, if lower than the rate of the purchasing company. Prior to 1995, the purchaser had to take over the target company's (predecessor's) experience rating and accept a combined experience rate calculation in the future.

The Report ignores the distinction drawn in the Georgia Code between acquiring "substantially all of the business or assets" of any employer under O.C.G.A. Section 34-

⁷ Buying and Selling Privately Held Businesses, John C. Beane, Trouman Sanders, LLP, prepared for the Institute of continuing Legal Education in Georgia, Program dated January 9, 1998.

8-153 and "acquiring the organization", as that phrase is used in O.C.G.A. Section 34-8-33 to define "employer" under the UI law.⁸ Clearly, the statutory language used to define an employer is different than the language used to define the establishment of tax rate liability as a "successor" employer. Acquiring substantially all of the business or assets of the company is not the same as acquiring the organization itself, and there is no indication that the successor statute (O.C.G.A. Section 34-8-153) was intended to require, include or exclude acquiring "the organization." O.C.G.A. Section 34-8-153 focuses on acquisition of business or assets, not corporate stock ownership. The Georgia legislature used different language to describe becoming an employer under the unemployment system and becoming a successor employer under the unemployment system. Both sets of terms were promulgated in the same year. Therefore, we must give separate meaning to the phrases, as clearly intended by the Legislature. This distinction in Georgia law was pointed out and reviewed with the Report authors on four separate occasions but is still ignored in the Report.

⁸ 34-8-33.

As used in this chapter, the term "employer" means:

- (8) Any employing unit which acquired the organization, trade or business, or substantially all of the assets of another which at the time of such acquisition was an employer subject to this chapter;
- (9) Any employing unit which acquired the organization, trade or business, or substantially all of the assets of another employing unit, if the employment record of such employing unit subsequent

CONCLUSION:

The August 20, 1998, Draft Report overstates a case for abuses from the employee leasing company industry in Georgia. The practices described are generally legal and are commonly utilized by members of other industries to achieve tax savings. As stated in the precursor to this Report, Analysis of the Impact of Employee Leasing on Unemployment Insurance Programs, at Section 4.4.1, "Measuring the Effects on State UI Tax Rates," conducted by KRA Corporation under contract to the United States Department of Labor:

Measuring the effects the leasing industry has on State UI trust funds using UI wage records is not a straightforward task. Ideally, one would want to calculate the taxes paid by and benefits charged to the client firm for the year of the leasing arrangement and the taxes paid by and benefits charged to the leasing firm for the year after the leasing arrangement for only those employees who were leased. This is impractical because of the difficulty involved in accurately identifying the leased employees who collected benefits charged to either the leasing or client firm... Instead, a more practical approach is to compare the UI tax rates paid by both the leasing and client firms in the year in which the changeover occurred. However, because of changes in State tax schedules from one year to the next, this may not be an accurate measurement in the differences between the leasing firms' and client firms' tax rates. *Because most States use multiple years' (generally 3 to 5) worth of payroll taxes and charged benefits to calculate their experience-rated tax rate, an analysis of the effects of leasing arrangements on leasing firms' experience rating would require the use of data taken over an extended period of time. However, such an analysis would be unsatisfactory because, with the passage of time, it would be difficult to attribute such experience-rating changes only to the leasing arrangements.* (Emphasis supplied)

to such acquisition together with the employment record of the acquired unit prior to such acquisition, both within the same calendar year, would be sufficient to meet any other definition of employer within this chapter.

Upon final review, we feel that the recommendations in the Report that the Georgia Department of Labor pursue recovery of UI Trust Fund "losses" is unwarranted, that the tax-saving strategies employed by employee leasing companies are not illegal per se, and that there have been no clear-cut violations of the Georgia successor statute. We further believe that such any effort at litigation would not lead to either criminal convictions or civil victories.

We can only speculate with the Report authors on whether or not the use of affiliate company purchases and mergers for tax advantage by employee leasing companies was contemplated by the Legislature when O.C.G.A. Section 34-8-153 was enacted or last amended; it is clear, however, that the Legislature approved such action by the business community in general. The Department is not the proper party to challenge the intent of the Legislature by unilaterally disallowing the use tax successorship by members of a single industry. Singling out the employee leasing industry for separate treatment in legislation aimed just at that industry is not legally feasible.

Regarding the Report's recommendations on procedures used to identify leasing companies, Georgia law does not require an employee leasing company to register with the Department to report its activity or existence. In fact, the Georgia Legislature rejected repeated efforts to license the industry in both the 1995-96 and 1997-98 Sessions (H.B. 555; H.B. 26; S. B. 126, respectively). Licensing would have required identification of leasing company owners/principals. Upon the recommendation of the Georgia Occupational Regulation Review Council, a special council of ten state government department heads and regulatory officers who review all proposed

occupational regulatory legislation, licensing of the employee leasing industry was rejected by the Georgia General Assembly, the industry having a 0.2% failure rate with no recent company failures, no complaints to the Office of Consumer Affairs, and no other substantial regulatory issues. It is only to achieve certain reporting benefits under the law, i.e., consolidated reporting under the employee leasing company's own unemployment tax rate, that a leasing company must register with the Department and post a surety bond. The Department has a direct interest in securing surety bonds from all leasing companies who are utilizing a single unemployment tax rate for reporting purposes, and we therefore concur with the Report recommendations regarding techniques to better identify employee leasing companies in this state, although not for the reasons given by the Report authors. Again, any employee leasing company reporting under its clients' accounts has no obligation to register with the Department. The Report does not indicate which of the "41%" of the total leasing companies in this state (which were previously unknown to the Department) were reporting under client accounts; to the extent the companies identified were reporting under client accounts, that fact would further invalidate the conclusions drawn by the Report.

It is worthwhile to note that the Bureau of Labor Statistics has established a new industrial classification (formerly SIC code) for Professional Employer Organizations (PEOs), identified in Georgia law as employee leasing companies (See Georgia DOL Regulations at 300-2-7-.07). The BLS plan is to establish two classifications: (1) PEOs (employee leasing companies) that primarily offer PEO services and (2) other personnel firms, like temporary, personnel recruiter firms, that primarily offer other employer services. The new classification will be a six-digit number, 561330, based on the North

American Industrial Classification System (NAICS) and, when the transition is completed from the current collective SIC Code 7363 to the new NAICS Code 561330 in the spring of the year 2000, identifying employee leasing companies/PEOs will be facilitated without additional effort on the part of the Georgia Department of Labor.

In summary, we recommend further review, correction, and revision of the Report in accordance with the information and comments presented here and during the course of the audit.