



MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT



THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

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– Article IV, Section 53 of the Michigan Constitution

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Michigan *Office of the Auditor General* **REPORT SUMMARY**

Performance Audit

Collection of Delinquent Unemployment Taxes and Reimbursements

Unemployment Insurance Agency Department of Licensing and Regulatory Affairs

Report Number:
641-0316-11

Released:
January 2012

The Unemployment Insurance Agency's (UIA's) primary responsibility is to collect State unemployment taxes and reimbursements from employers and pay State and federal unemployment insurance (UI) benefits to eligible unemployed persons. In fiscal years 2008-09 and 2009-10, UIA collected unemployment taxes and reimbursements totaling \$3.0 billion from Michigan employers, which included \$94.3 million in delinquent taxes and reimbursements. As of December 31, 2010, UIA's records identified approximately \$394.5 million in delinquent taxes, interest, and penalties, of which UIA estimated up to \$252.3 million was collectible.

Audit Objective:

To assess the effectiveness and efficiency of UIA's efforts to maximize its collection of delinquent unemployment taxes and reimbursements.

Audit Conclusion:

We concluded that UIA's efforts to maximize its collection of delinquent unemployment taxes and reimbursements were neither effective nor efficient. We noted four material conditions (Findings 1 through 4) and two reportable conditions (Findings 5 and 6).

Material Conditions:

UIA's Collections Unit (CU) and Tax Enforcement Unit (TEU) did not initiate sufficient and timely efforts to collect delinquent State Unemployment Tax Act (SUTA) taxes from contributing employers. As a result, CU and TEU likely missed opportunities for significant collections of delinquent SUTA taxes (Finding 1).

CU did not determine if delinquent contributing employers owned real property before CU filed real property liens against the employers. Also, CU did not have controls to verify that county Register of Deeds offices promptly recorded UIA's liens and lien discharges and that CU documented the lien recording and discharge information in UIA's records. As a result, CU inefficiently used significant collection resources filing and discharging liens that provided limited value to its collections process. Also, UIA could not ensure that it promptly secured its interest in delinquent employers' real property and promptly unencumbered employers' real property to avoid unnecessarily restricting the property's disposition (Finding 2).

UIA did not use available data and data analysis resources to proactively identify and investigate employers potentially involved in SUTA dumping, potentially misclassifying some or all of their

employees as independent contractors, in bankruptcy, or not registering with UIA. As a result, it is likely that UIA limited its SUTA tax collections and its operational efficiency, which negatively impacted the solvency of the Unemployment Compensation Fund (Finding 3).

UIA's Tax Office did not timely initiate actions affecting contributing employers' SUTA tax accounts. Also, UIA's Tax Office did not ensure that UIA's master employer files contained up-to-date information. These conditions likely resulted in substantial losses of SUTA tax collections and in significant processing inefficiencies (Finding 4).

Reportable Conditions:

CU did not effectively determine if employers remained in business before estimating and attempting to collect employers' unpaid SUTA taxes. Also, CU inaccurately estimated employers' unpaid SUTA taxes using the employers' gross wages rather than taxable wages. As a result, CU likely incurred significant collection costs while pursuing estimated SUTA taxes from employers with no liability for them. Also, CU's estimation methodology significantly overstated employers' SUTA taxes owed and the corresponding liens it placed on the employers' real and personal property (Finding 5).

UIA did not ensure that applicable reimbursing employers provided UIA with security collateral. As a result, our review identified that UIA lost otherwise collectible reimbursement payments and likely will incur additional losses in the future (Finding 6).

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Agency Response:

Our audit report contains 6 findings and 9 corresponding recommendations. UIA's preliminary response indicates that it agrees with 7 recommendations and partially agrees with 2 recommendations.

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January 20, 2012

Mr. Steve Arwood, Director
Unemployment Insurance Agency
Department of Licensing and Regulatory Affairs
Cadillac Place
Detroit, Michigan
and
Mr. Steven H. Hilfinger, Director
Department of Licensing and Regulatory Affairs
Ottawa Building
Lansing, Michigan

Dear Mr. Arwood and Mr. Hilfinger:

This is our report on the performance audit of the Collection of Delinquent Unemployment Taxes and Reimbursements, Unemployment Insurance Agency, Department of Licensing and Regulatory Affairs.

This report contains our report summary; description of agency; audit objective, scope, and methodology and agency responses; comment, findings, recommendations, and agency preliminary responses; and a glossary of acronyms and terms.

The agency preliminary responses were taken from the agency's response subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a plan to comply with the audit recommendations and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

We appreciate the courtesy and cooperation extended to us during this audit.

Sincerely,

A handwritten signature in black ink, appearing to read "Thomas H. McTavish".

Thomas H. McTavish, C.P.A.
Auditor General

TABLE OF CONTENTS

COLLECTION OF DELINQUENT UNEMPLOYMENT TAXES AND REIMBURSEMENTS UNEMPLOYMENT INSURANCE AGENCY DEPARTMENT OF LICENSING AND REGULATORY AFFAIRS

	<u>Page</u>
INTRODUCTION	
Report Summary	1
Report Letter	3
Description of Agency	6
Audit Objective, Scope, and Methodology and Agency Responses	8
COMMENT, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES	
Efforts to Maximize Collection of Delinquent Unemployment Taxes and Reimbursements	11
1. Collection Efforts for Delinquent SUTA Taxes	12
2. Real Property Liens	15
3. Use of Information	18
4. SUTA Tax Account Actions	22
5. Estimation of Unpaid SUTA Taxes	26
6. Security Collateral	29
GLOSSARY	
Glossary of Acronyms and Terms	32

Description of Agency

The federal Social Security Act of 1935 created the Unemployment Insurance Program as a joint federal-state partnership, with each state responsible for designing its own program within broad federal guidelines. In response to this Act, the Unemployment Insurance Agency (UIA), Department of Licensing and Regulatory Affairs, was created as the Michigan Employment Security Commission by the Michigan Employment Security Act of 1936, being Sections 421.1 - 421.75 of the *Michigan Compiled Laws*.

UIA aims to provide the highest quality unemployment insurance (UI) services to ensure the economic growth of Michigan, including its employers and its workers. UIA's primary responsibility is to collect State Unemployment Tax Act (SUTA) taxes from contributing employers* and reimbursements from reimbursing employers* and pay State and federal UI benefits to eligible unemployed persons. As of July 8, 2011, there were approximately 200,000 active contributing employers and approximately 5,000 active reimbursing employers. Contributing employers include all nonreimbursing employers with over \$1,000 in annual employee wages. Contributing employers pay quarterly taxes to UIA on the first \$9,000 of each employee's annual income. UIA annually calculates the tax rate for each employer based on several factors, including the employer's claims history. Reimbursing employers include nonprofit organizations, governmental entities, and Indian tribes and tribal units. A reimbursing employer reimburses UIA dollar-for-dollar for UI benefits paid to the employer's employees.

The State provides up to 26 weeks of UI benefits, which it funds with an employer payroll tax or employer reimbursements. As of June 30, 2011, various federally funded programs provided up to 73 additional weeks of UI benefits. UIA's SUTA tax receipts and employer reimbursements are deposited in the State's Unemployment Compensation Fund. Also, the Internal Revenue Service levies a payroll tax on Michigan employers to fund the federal share of extended UI benefit programs and UIA administrative costs and to provide loans to eligible states that do not have sufficient financial resources to meet their UI obligations. In fiscal years 2008-09 and 2009-10, UIA paid UI benefits totaling \$13.0 billion, whereas UIA's SUTA tax and reimbursement collections totaled only \$3.0 billion, which included \$94.3 million in delinquent SUTA

* See glossary at end of report for definition.

taxes and reimbursements. As of December 31, 2010, UIA's records identified approximately \$394.5 million in delinquent taxes, interest, and penalties. Because of various conditions cited in this report, we could neither readily verify the accuracy of this amount nor assess the collectibility of the underlying accounts. As of November 30, 2011, UIA estimated that up to \$252.3 million of this amount was collectible. To fund the revenue shortfall for these and prior years, the State borrowed from the federal government. As of June 30, 2011, the outstanding federal loans totaled \$3.2 billion.

UIA administers its SUTA tax and reimbursement collection activities from its central office in Detroit. During fiscal year 2009-10, UIA's operating expenditures were \$183.3 million. As of June 27, 2011, UIA had 918 regular full-time and 261 limited-term employees.

Audit Objective, Scope, and Methodology and Agency Responses

Audit Objective

The objective of our performance audit* of the Collection of Delinquent Unemployment Taxes and Reimbursements, Unemployment Insurance Agency (UIA), Department of Licensing and Regulatory Affairs, was to assess the effectiveness* and efficiency* of UIA's efforts to maximize its collection of delinquent unemployment taxes and reimbursements.

Audit Scope

Our audit scope was to examine the program and other records and processes of the Unemployment Insurance Agency related to the collection of delinquent unemployment taxes and reimbursements. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Our audit procedures, conducted from January through June 2011, primarily covered the period October 1, 2008 through June 30, 2011.

Audit Methodology

We conducted a preliminary review of UIA's operations to form a basis for defining our audit scope. Our preliminary review included reviewing UIA's organizational structure; interviewing various members of UIA management and staff; reviewing applicable State and federal laws, rules, codes, policies, procedures, and manuals; examining reports from various internal and external audits and reviews of UIA and similar organizations; identifying and examining pertinent management reports; conducting Internet research to identify industry standards and best practices; and obtaining an understanding of and documenting UIA's internal control* related to the collection of delinquent State Unemployment Tax Act (SUTA) taxes and reimbursements.

** See glossary at end of report for definition.*

To accomplish our objective, we reviewed UIA's use of telephone contacts, payment plans, real property* liens*, personal property* liens*, notices to withhold*, and civil judgments* to collect delinquent SUTA taxes or reimbursements from selected employers. Also, we verified whether employers owned real property in counties where UIA filed its real property liens. In addition, we compared selected employer data with that of the Department of Treasury and others to ascertain the accuracy of UIA's information. Further, we reviewed the accuracy of the estimated SUTA taxes owed by nonreporting employers. Also, we examined UIA's use of available tools for proactively identifying employers potentially involved in SUTA dumping*, potentially misclassifying some or all of their employees as independent contractors, in bankruptcy, or not registering with UIA. In addition, we examined UIA's efforts for obtaining security collateral from applicable reimbursing employers.

When selecting activities or programs for audit, we use an approach based on assessment of risk and opportunity for improvement. Accordingly, we focus our audit efforts on activities or programs having the greatest probability for needing improvement as identified through a preliminary review. Our limited audit resources are used, by design, to identify where and how improvements can be made. Consequently, we prepare our performance audit reports on an exception basis.

Agency Responses

Our audit report contains 6 findings and 9 corresponding recommendations. UIA's preliminary response indicates that it agrees with 7 recommendations and partially agrees with 2 recommendations.

The agency preliminary response that follows each recommendation in our report was taken from the agency's written comments and oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and the State of Michigan Financial Management Guide (Part VII, Chapter 4, Section 100) require UIA to develop a plan to comply with the audit recommendations and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

* See glossary at end of report for definition.

COMMENT, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

EFFORTS TO MAXIMIZE COLLECTION OF DELINQUENT UNEMPLOYMENT TAXES AND REIMBURSEMENTS

COMMENT

Background: The funding mechanism for the federal-state unemployment system was designed to accumulate benefit reserves during periods of economic growth so that it could pay unemployment insurance (UI) benefits during periods of economic decline. However, because of persistently high unemployment in Michigan, employer State Unemployment Tax Act (SUTA) taxes and reimbursements to the Unemployment Compensation Fund (UCF) fell significantly below the UI benefits paid from the UCF and rendered the UCF insolvent. In fiscal years 2008-09 and 2009-10, the Unemployment Insurance Agency (UIA) paid UI benefits totaling \$6.2 billion and \$6.8 billion, respectively, whereas UIA's SUTA tax and reimbursement collections totaled only \$1.4 billion and \$1.6 billion, respectively.

To continue paying UI benefits, Michigan borrowed from the federal government. As of June 30, 2011, these loans totaled \$3.2 billion. To help repay these loans and restore solvency to the UCF, it is imperative that UIA maximize its collection on current accounts and on the approximately \$394.5 million in delinquent taxes, interest, and penalties that were outstanding as of December 31, 2010.

Audit Objective: To assess the effectiveness and efficiency of UIA's efforts to maximize its collection of delinquent unemployment taxes and reimbursements.

Audit Conclusion: We concluded that UIA's efforts to maximize its collection of delinquent unemployment taxes and reimbursements were neither effective nor efficient. Our assessment disclosed four material conditions*:

- UIA's Collections Unit (CU) and Tax Enforcement Unit (TEU) did not initiate sufficient and timely efforts to collect delinquent SUTA taxes from contributing employers (Finding 1).
- CU did not determine if delinquent contributing employers owned real property before CU filed real property liens against the employers. Also, CU did not have controls to verify that county register of deeds offices promptly recorded UIA's liens

* See glossary at end of report for definition.

and lien discharges and that CU documented the lien recording and discharge information in UIA's records (Finding 2).

- UIA did not use available data and data analysis resources to proactively identify and investigate employers potentially involved in SUTA dumping, potentially misclassifying some or all of their employees as independent contractors, in bankruptcy, or not registering with UIA (Finding 3).
- UIA's Tax Office did not timely initiate actions affecting contributing employers' SUTA tax accounts. Also, UIA's Tax Office did not ensure that UIA's master employer files contained up-to-date information (Finding 4).

Our assessment also disclosed two reportable conditions* related to estimation of unpaid SUTA taxes and security collateral (Findings 5 and 6).

FINDING

1. Collection Efforts for Delinquent SUTA Taxes

UIA's CU and TEU did not initiate sufficient and timely efforts to collect delinquent SUTA taxes from contributing employers. As a result, CU and TEU likely missed opportunities for significant collections of delinquent SUTA taxes.

Although CU and TEU are jointly responsible for collecting delinquent SUTA taxes from employers, CU is responsible for the initial collection efforts on all delinquent accounts. These initial collection efforts include calling employers, filing real and personal property liens, and establishing payment plans. When CU exhausts these initial collection efforts without success, it is responsible for referring accounts exceeding \$10,000 to TEU for more aggressive collection actions. The more aggressive collection actions that TEU is responsible for initiating and that CU is responsible for initiating on delinquent accounts totaling \$10,000 or less include executing notices to withhold, which allow for money to be taken directly from employer bank accounts, and seeking civil judgments through the Department of Attorney General.

* See glossary at end of report for definition.

As of December 31, 2010, there were 101,158 employers that owed approximately \$394.5 million in delinquent SUTA taxes, interest, and penalties. To assess the completeness and timeliness of CU's and TEU's collection efforts, we selectively reviewed 20 employer accounts with delinquent SUTA taxes, interest, and penalties totaling approximately \$2.0 million. We noted:

- a. CU did not attempt to contact 16 (80.0%) employers by telephone in accordance with UIA collection procedures when these employers did not respond to UIA's 325 automated billings and correspondence. Personal contact with debtors is a collection practice generally used and recognized as a best practice by collection professionals.

These 16 employers had delinquent SUTA taxes, interest, and penalties totaling \$1.9 million, which individually ranged from \$4,755 to \$327,720. The following table shows the number of quarters that the 16 employers were delinquent as of February 14, 2011:

	Number of Quarters Delinquent			
	1 to 3 Quarters	4 to 7 Quarters	8 to 11 Quarters	12 or More Quarters
Number of Delinquent Employers	2	3	7	4

- b. CU did not issue notices to withhold in order to identify and levy* the financial accounts of 6 (75.0%) of 8 applicable employers as required by UIA's draft collection procedures and as authorized by Section 421.15(b) of the *Michigan Compiled Laws*. Tax Office management informed us that CU was required to comply with the draft collection procedures even though they had not been formally approved.
- c. CU did not pursue civil judgments against 7 (77.8%) of 9 applicable employers with delinquent balances totaling at least \$1,000 as required by UIA's draft collection procedures and as authorized by Section 421.15(c) of the *Michigan Compiled Laws*. A civil judgment extends the statute of limitations for collecting a delinquent account by 10 years from the date of the judgment.

* See glossary at end of report for definition.

- d. CU did not refer 10 (100.0%) of 10 applicable employer accounts to TEU. As a result, TEU could not identify and levy the employers' financial accounts and/or pursue civil judgments against them, as required by UIA's draft collection procedures.

In addition, from October 1, 2008 through December 31, 2010, UIA wrote off as uncollectible approximately \$35.6 million in delinquent SUTA taxes, interest, and penalties for 26,984 contributing employers. We selected and reviewed UIA's collection activities for 10 employer accounts totaling \$78,394 and noted that UIA had not initiated any of the actions described in parts a. through d. to collect 5 (50.0%) of the accounts totaling \$13,578 or pursued a civil judgment against 3 (30.0%) of the remaining employers with delinquent SUTA taxes totaling \$35,334.

CU management informed us that CU lacked sufficient staffing to complete the required collection procedures. However, it is important to note that CU could have reduced its work load and likely enhanced UIA's overall collections by referring applicable accounts to TEU. CU management indicated that competition for collections between CU and TEU, together with a lack of definitive referral time frames or conditions, likely contributed to CU's lack of referrals to TEU. Additional efficiencies gained by implementing the recommendations in Findings 2 through 5 of this report could provide sufficient staffing and other resources for CU to significantly improve its collections efforts.

RECOMMENDATION

We recommend that UIA's CU and TEU initiate sufficient and timely efforts to collect delinquent SUTA taxes from contributing employers.

AGENCY PRELIMINARY RESPONSE

UIA agrees and stated that it is completely reviewing the collections process and procedure for both CU and TEU. The review will establish strict protocols for all collection activities and maintenance of employers' account histories. UIA will assess staff work loads and restructure CU to include a group dedicated to the early detection of delinquencies and the implementation of proactive practices to engage delinquent employers. Further reorganization will occur where communications barriers among units affect performance.

UIA stated that it is migrating to a new computer system with the system's tax collection functionality expected to be completed in early fall 2012. The new system will allow for comprehensive changes to how UIA can report and detail tax delinquencies. UIA also stated that, after our audit fieldwork, it largely reorganized the management and functions of the organizational units included in this audit.

FINDING

2. Real Property Liens

CU did not determine if delinquent contributing employers owned real property before CU filed real property liens against the employers. Also, CU did not have controls to verify that county register of deeds offices promptly recorded UIA's liens and lien discharges and that CU documented the lien recording and discharge information in UIA's records.

As a result, CU inefficiently used significant collection resources filing and discharging liens that provided limited value to its collections process. Also, UIA could not ensure that it promptly secured its interest in delinquent employers' real property and promptly unencumbered employers' real property to avoid unnecessarily restricting the property's disposition.

As of June 1, 2011, CU employed 10 account examiners whose primary responsibility was to collect delinquent SUTA taxes using liens and various other collection methods. We interviewed 5 of the account examiners who informed us that they spent from 45% to 65% of their time processing liens. CU informed us that some account examiners also worked overtime processing liens. However, CU could not provide us with the amount or associated costs of this overtime. Further, CU informed us that various other UIA employees helped process liens, although it was not a significant portion of the employees' overall work load. In addition to the significant labor costs associated with lien processing, UIA incurred \$2 fees for recording and discharging each lien and incurred costs for printing and mailing lien warning letters and liens. As noted in parts a. through c. of this finding, most of these efforts and lien processing costs provided limited value to the collections process.

Section 421.15(e) of the *Michigan Compiled Laws* provides for UIA to place a lien on the real property of employers that do not pay their SUTA taxes timely. Liens are to be filed with and recorded by the county register of deeds office in which the real property subject to lien is located. Liens are only valid on real property that an employer owns and which is located in the specific county that the lien is recorded. Once recorded, a lien restricts the sale of the applicable employer's property pending satisfaction of the lien. In addition, UIA policy requires CU employees to promptly document the official lien recording and discharge information in UIA's records.

From October 1, 2008 through May 17, 2011, UIA filed 77,875 liens on 37,614 employers. Generally, CU and the Reimbursing Unit (RU) were responsible for filing UIA's liens on contributing and reimbursing employers, respectively. We selected and reviewed the lien filings, discharges, and recordings for 20 contributing employers and 10 reimbursing employers with delinquent SUTA taxes during the aforementioned period and 10 contributing employers with delinquent SUTA taxes that were written off as uncollectible during the aforementioned period. We noted:

- a. CU and RU filed 97 liens on 30 employers; however, only 9 (9.3%) of the liens were placed in counties in which the employers owned real property. Consequently, 88 (90.7%) of the 97 real property liens (all 88 were for contributing employers) did not add value to the collections process and did not result in any related collections of delinquent SUTA taxes.
- b. CU did not document the recording information for 20 (20.8%) of 96 liens and 4 (28.6%) of 14 lien discharges that CU filed for 29 (96.7%) of the 30 contributing employers. Also, we examined our analysis of UIA's lien recording information and noted that UIA lacked recording information for 25,412 (33.6%) of all 75,589 liens that CU or RU had filed at least 90 days prior to our analysis. UIA could not readily determine if the register of deeds offices received and recorded the lien filings or if they had recorded the liens but did not provide UIA with the recording information. In addition, UIA could not determine if CU failed to input the recording information into its records.

The timely filing and recording of liens helps ensure that employers do not dispose of real property without first paying their delinquent SUTA taxes. Also, prompt filing and recording of lien discharges avoids unnecessarily restricting employers' disposition of their real property.

- c. CU inappropriately filed 4,141 liens in Wayne County for employers whose business addresses on file with UIA were outside the State of Michigan. Because liens are only effective on employers' real property owned and located in the county where the liens are recorded, these 4,141 liens did not provide value to CU's collections process.

As noted in Finding 1, CU often failed to use many of the collection methods available to it when pursuing collection of delinquent SUTA taxes. CU informed us that, generally, this occurred because of a lack of sufficient staffing. Our limited testing disclosed that such failure resulted in CU missing several collection opportunities. By redirecting its resources from ineffective lien processing to other collection methods, CU may significantly improve its collection of delinquent SUTA taxes.

RECOMMENDATIONS

We recommend that CU determine if delinquent contributing employers own real property before CU files real property liens against the employers.

We also recommend that CU establish controls to verify that county register of deeds offices promptly record UIA's liens and lien discharges and that CU documents the lien recording and discharge information in UIA's records.

AGENCY PRELIMINARY RESPONSE

UIA agrees and stated that the U.S. Department of Labor's (USDOL's) Tax Performance System (TPS) requires the use of tax liens as a collection tool. To improve the value of the lien process, UIA will:

- (1) Implement a new process to check the Consolidated Lead Evaluation and Reporting (CLEAR) public records for real property before issuing manual liens. CLEAR contains both public and private information that is updated in real time. CLEAR will allow UIA to determine if and where applicable

employers own real property. After researching CLEAR, UIA will only issue manual liens on those employers that own real property in Michigan counties. UIA will continue to search CLEAR every quarter to monitor repeat employers that again meet UIA's lien requirements. If an employer is found to own real property in Michigan, UIA will lien the real property.

- (2) Discontinue filing liens in Wayne County for employers whose business addresses are outside Michigan.
- (3) Pursue a computerized solution for determining whether real property exists in a county before creating a lien.
- (4) Pursue the electronic exchange of liens and recording information with Michigan counties where available.

FINDING

3. Use of Information

UIA did not use available data and data analysis resources to proactively identify and investigate employers potentially involved in SUTA dumping, potentially misclassifying some or all of their employees as independent contractors, in bankruptcy, or not registering with UIA. As a result, it is likely that UIA limited its SUTA tax collections and its operational efficiency, which negatively impacted the solvency of the UCF.

SUTA dumping is a scheme used by employers to inappropriately lower their SUTA tax rate and, ultimately, the amount of their SUTA tax liability. SUTA Dumping Detection System* (SDDS) software is a customizable program provided by the USDOL's Employment and Training Administration, for analyzing employer data for indicators of SUTA dumping. We noted:

- a. UIA did not use SDDS software to proactively identify employers potentially engaged in SUTA dumping. Instead, UIA limited its use of the software to assisting in the investigation of employers already identified for potential SUTA dumping through various nonproactive means.

** See glossary at end of report for definition.*

Recognizing the negative financial impact of SUTA dumping on the UCF, Sections 421.22b(2)(e) and 421.22b(2)(f) of the *Michigan Compiled Laws* require UIA to establish procedures to identify employers involved in SUTA dumping and to provide an annual report to the Legislature detailing these procedures. In its 2010 annual report, UIA indicated that it used its SDDS software for this purpose. However, as previously stated, UIA used the software only as an investigational tool for employers already suspected of SUTA dumping.

We surveyed 5 state unemployment agencies, and 4 (80.0%) states indicated that they used the SDDS software or a similar data resource to analyze employer data and identify, for investigation, employers with high employee movement rates; large SUTA tax rate changes; employers sharing the same federal identification number, telephone number, and/or address; and other SUTA dumping indicators.

UIA reported that it collected approximately \$2.3 million in calendar year 2010 related to SUTA dumping. By using SDDS software to proactively identify and investigate potential SUTA dumpers, UIA could increase these collections.

- b. UIA did not use employer-reported 1099 data provided by the Internal Revenue Service (IRS) to proactively identify and investigate employers that may have misclassified some or all of their employees as independent contractors. While some employers may misclassify one or more of their employees in error, others may do so to avoid paying SUTA, Federal Unemployment Tax Act (FUTA) taxes, and other payroll taxes on the wages paid to their employees. Not only does this practice deny the UCF of needed contributions, it causes the applicable employees to lose UI benefits and labor law protections, such as minimum and prevailing wage, overtime, family and medical leave, workers' compensation coverage, and retirement and Social Security benefits.

As noted by the U.S. Government Accountability Office, employee misclassification is a national problem that results in the annual loss of millions of dollars in SUTA, FUTA, and other state and federal payroll taxes. The IRS's sharing of 1099 data with state unemployment agencies was established

to help address this problem. In fact, 2 of the 5 state unemployment agencies that we surveyed responded that they used the IRS-provided 1099 data for this purpose. And, according to the USDOL's Bureau of Labor Statistics, there were approximately 10.3 million individuals classified as independent contractors in 2010. Thus, the continued identification of improperly classified employees is imperative and will help to eliminate the deficit in the UCF.

UIA informed us that, until early 2010, it used the IRS-provided 1099 data to identify misclassified employees but discontinued the practice after the IRS criticized UIA for not sufficiently protecting the 1099 data.

- c. UIA did not target its field audits at employers with an increased risk of underpaying their SUTA taxes. Instead, with the exception of employer audits generated from internal and external referrals, UIA randomly selected the employers it chose for audit. While these audits often identified misclassified employees and underreported wages, the use of targeted field audits should improve UIA's SUTA tax collections.

The use of targeted field audits is a best practice used by the Michigan Department of Treasury to help ensure the effective use of its limited audit resources. Also, 4 of the 5 state unemployment agencies that we surveyed informed us that they too used targeted field audits for this purpose. For example, the unemployment agencies targeted some of their audit activities at employers within specific industries in which the misclassification of employees was particularly prevalent (e.g., construction and remodeling) or at individual employers cited for misreporting their taxable wages and underpaying their SUTA taxes during prior audits.

- d. UIA did not conduct periodic searches of the federal Judiciary's Public Access to Court Electronic Records (PACER) database to timely identify employers that filed for bankruptcy protection in either of the federal bankruptcy courts located in Michigan. Timely identification of bankrupt employers is necessary for helping UIA ensure that it promptly files claims with the applicable bankruptcy court for delinquent SUTA taxes owed by the bankrupt employers. Failure to file or promptly file claims with the courts may result in lost SUTA tax collections.

We reviewed selected bankruptcy filings identified in PACER for the two bankruptcy courts located in Michigan for the period October 1, 2008 through December 31, 2008. We identified 37 employers that were registered with UIA. UIA had not identified and designated in its employer database that 9 (24.3%) of the 37 employers were bankrupt. Two (22.2%) of the 9 employers owed delinquent SUTA taxes totaling \$4,139.

UIA stated that a lack of staffing precluded it from completing the periodic searches.

- e. UIA did not establish a comprehensive data sharing arrangement with the Department of Treasury as permitted under Section 205.28 of the *Michigan Compiled Laws*. Although UIA had access to some of the Department of Treasury's data on an employer-by-employer basis, UIA's access was not sufficient for it to conduct a periodic cross-match of its employer database with the Department of Treasury's employer database. Such a cross-match would help UIA timely identify employers that had not registered with and paid their SUTA taxes to UIA, that had underreported their employee wages and corresponding SUTA taxes, that had discontinued their operations, etc. Such an arrangement could provide similar benefits to the Department of Treasury in its collection of employer payroll taxes.

RECOMMENDATION

We recommend that UIA use available data and data analysis resources to proactively identify and investigate employers potentially involved in SUTA dumping, potentially misclassifying some or all of their employees as independent contractors, in bankruptcy, or not registering with UIA.

AGENCY PRELIMINARY RESPONSE

UIA agrees. UIA stated that it has had data sharing discussions with the IRS and the Michigan Department of Treasury to obtain access to the most current information available for determining if employers are properly registered with UIA. UIA also stated that it is presently investigating, as part of its system rewrite project, the utilization of Department of Treasury data available in the State's data warehouse for automated cross-match verification purposes.

UIA informed us that its Field Audit Unit has started a review of the audits that it conducted during the past two calendar years to identify those industries with the most audit adjustments related to employee misclassification. UIA will use the results of this review, along with an increased use of SDDS software, to identify employers potentially engaged in SUTA dumping. UIA will also use IRS reports of employer-reported 1099 data to target and investigate employers that may have misreported their taxable wages and underpaid their SUTA taxes. UIA stated that its 1099 Unit is understaffed and that it is addressing this condition.

UIA will determine how it can best use the federal Judiciary's PACER database to timely identify the Michigan employers that filed for bankruptcy protection.

FINDING

4. SUTA Tax Account Actions

UIA's Tax Office did not timely initiate actions affecting contributing employers' SUTA tax accounts. Also, UIA's Tax Office did not ensure that UIA's master employer files contained up-to-date information. These conditions likely resulted in substantial losses of SUTA tax collections and in significant processing inefficiencies.

We reviewed UIA's efforts to collect delinquent SUTA taxes from 20 contributing employers. We noted:

- a. UIA did not consistently complete its investigation of potential SUTA dumping cases and issue related liability determinations and assessments in a timely manner. For example, it took UIA 596 days to conduct a SUTA dumping investigation for one employer and an additional 336 days for UIA to issue its related liability determination and SUTA tax assessment. Unbeknownst to UIA, the employer discontinued business approximately four weeks after UIA completed its SUTA dumping investigation. Consequently, it is unlikely that UIA will be able to collect the \$48,333 in SUTA taxes, interest, and penalties that it assessed to the employer. Not included within this amount were SUTA taxes, interest, and penalties totaling \$15,305 that UIA was barred by statute from assessing the employer because the debt was too old.

- b. UIA did not consistently investigate and determine whether the purchase of employers' businesses by other employers constituted transfers of business as defined by Section 421.22 of the *Michigan Compiled Laws*. When UIA determines that such purchases are transfers of business, it must include all or part of the transferor's (i.e., predecessor's*) UI claims history in a recalculation of the transferee's (i.e., successor's*) SUTA tax rate. By failing to make these determinations, UIA mistakenly continued to assess and attempt to collect SUTA taxes from the predecessor employers that were no longer in business. Also, UIA did not recalculate new SUTA tax rates for the successor employers by taking into account the predecessor employers' UI claims histories.

For example, on April 8, 2010, Employer A notified UIA that it purchased Employer B on May 31, 2009. UIA noted the potential transfer of business in Employer B's account history but did not initiate a referral to UIA's Tax Status Unit for it to investigate and make an official determination. Instead, UIA estimated and assessed Employer B delinquent SUTA taxes, interest, and penalties for 4 additional quarters. On February 2, 2011, UIA received a protest letter from Employer A regarding the SUTA tax assessments sent to Employer B and reiterated that it had purchased Employer B. Again, UIA failed to refer the information to the Tax Status Unit to investigate and issue a determination on the potential transfer of business. In total, UIA inappropriately assessed Employer B over \$200,000 in SUTA taxes, interest, and penalties. Although Employer A paid SUTA taxes on the employees it acquired from Employer B, it did so at a rate that was 5.4% lower than if UIA had appropriately recalculated the rate taking into account Employer B's prior UI claims history.

- c. UIA did not consistently refer employer accounts to CU after determining the employers' liability for delinquent SUTA taxes. For example, the Tax Status Unit determined that an employer owed \$13,821 in delinquent SUTA taxes as a successor employer in a transfer of business transaction. However, the Tax Status Unit did not refer the account to CU for collection. Because the employer is no longer in business, it is unlikely that CU will collect the delinquent taxes.

* See glossary at end of report for definition.

- d. UIA did not consistently update the telephone number, address, and/or mail delivery indicator (deliverable or undeliverable) in its master employer files. In some instances, UIA noted these changes in the employers' history records but did not update the information in its master employer files.

UIA's data system accesses the master employer files to determine if and where to send assessments, liens, and other SUTA tax-related correspondence to employers. When an employer's mail delivery indicator is designated undeliverable, UIA discontinues sending correspondence to the employer.

To help ensure that it stops generating undeliverable assessments, liens, and other information, UIA must ensure that its mail delivery indicators are accurate. For example, on December 31, 2010, UIA received an employer's returned mail which stated that it was not deliverable as addressed and could not be forwarded. UIA did not obtain a new address for the employer or change its mail delivery indicator for the employer to undeliverable. Consequently, at the time of our review on June 1, 2011, UIA had sent the employer seven additional pieces of correspondence to the same undeliverable address.

The Tax Office has struggled with timely initiating actions affecting employers' SUTA tax accounts for many years. Despite reorganizing several times, problems with the timely initiation of such actions still persist.

RECOMMENDATIONS

We recommend that UIA's Tax Office timely initiate actions affecting contributing employers' SUTA tax accounts.

We also recommend that UIA's Tax Office ensure that UIA's master employer files contain up-to-date information.

AGENCY PRELIMINARY RESPONSE

UIA agrees. UIA informed us that, to improve its timeliness in completing SUTA dumping investigations, it issued production standards in September 2010 and, starting in 2011, it required SUTA dumping cases to be processed on a first-in,

first-out basis. Also, UIA stated that it is developing timeliness standards for the issuance of liability determinations and assessments, which UIA will implement and measure beginning in 2012.

UIA informed us that, to ensure that it properly investigates and determines the transfers of business according to Section 421.22 of the *Michigan Compiled Laws*, it will continue to request supporting documentation for all business transfers. UIA also informed us that, although it requests a completed discontinuance form, Schedule B, purchase agreement, or bill of sale to process a successorship, employers often fail to comply with UIA's request. UIA stated that, in these instances, it uses the "best information" available to process the business transfers to meet the USDOL's computed measure of issuing determinations within 90 days of the business transfer. UIA also stated that, to improve the quality of determinations issued, it is adding an automated random selection process to UIA's automated work distribution system in August 2011. UIA indicated that it will review the accuracy and completeness of selected items.

To ensure that all employers liable for delinquent SUTA taxes are referred to CU, UIA will develop and implement new controls as part of the system rewrite project. Specifically, the system will systematically assign debts on predecessors' accounts to the successors as permitted under Section 15(g) of the Michigan Employment Security (MES) Act. UIA informed us that, in the meantime, it provided liability examiners with instructions to follow existing procedures regarding the referrals of these debts so that the assessments are issued properly.

To ensure that its master employer files contain up-to-date information, UIA will develop and implement new controls as part of the system rewrite project. The system will include an automated audit trail that will track the entry of all updated employer information in the master files, thus replacing the current manual entries in the employers' account histories. This change eliminates the option of staff entering changes in the account histories and not making the changes to the master files. UIA informed us that it has already implemented an automated change of the mail delivery indicator to undeliverable when UIA changes an employer's status to nonliable and vice versa.

UIA will encourage all employers to expand their use of UIA's on-line services. UIA stated that, currently, employers are able to update fields such as e-mail address, telephone number, business address, and mailing address. These employer-initiated changes are automatically updated to the master employer files. Employer-entered updates will be expanded and, thereby, reduce manual processing by UIA personnel in the system rewrite project.

FINDING

5. Estimation of Unpaid SUTA Taxes

CU did not effectively determine if employers remained in business before estimating and attempting to collect employers' unpaid SUTA taxes. Also, CU inaccurately estimated employers' unpaid SUTA taxes using the employers' gross wages* rather than taxable wages*.

As a result, CU likely incurred significant collection costs while pursuing estimated SUTA taxes from employers with no liability for them. Also, CU's estimation methodology significantly overstated employers' SUTA taxes owed and the corresponding liens it placed on the employers' real and personal property.

Michigan Administrative Code R 421.121(2) requires contributing employers to submit quarterly contribution reports to UIA and to pay the appropriate SUTA taxes on taxable wages (i.e., the first \$9,000 of each employee's annual wages reported therein by the twenty-fifth day of the month following each calendar quarter). Also, Section 421.15(i) of the *Michigan Compiled Laws* provides for UIA to estimate an employer's SUTA tax liability from available information when the employer fails to submit a quarterly contribution report identifying its gross and taxable wages. In addition, a UIA draft operating procedure requires CU to send nonreporting employers a series of up to eight different written communications over several months to inform the employer of its delinquency, question the employer about the potential discontinuance of its business operations, estimate and assess the employer's SUTA tax liability, and place a lien on the employer's real and personal property for the amount of the estimated liability. CU repeats this process for up to eight consecutive quarters.

* See glossary at end of report for definition.

CU informed us that, for the 10 quarters ended March 31, 2011, contributing employers failed to file 299,607 quarterly contribution reports. We reviewed CU's efforts to determine whether 18 employers that did not file quarterly contribution reports and owed estimated SUTA taxes for consecutive quarterly periods remained in business during the applicable quarters. Apart from mailing the employers one questionnaire regarding the potential discontinuance of their operations, all of which went unanswered, CU did not take any action to determine if the employers remained in business during the quarters. By examining information sources available to UIA (i.e., the last quarterly wage reports filed by the applicable employers and business discontinuance forms filed with the Department of Treasury), we noted that 12 (66.7%) of the 18 employers appeared to have discontinued business before CU made some or all of its SUTA tax estimates for them. CU sent the 12 employers 243 communications and assessed the employers an estimated \$1,498,247 for unpaid SUTA taxes for quarters after UIA could have known that the employers discontinued business.

Because CU generally estimated nonreporting employers' SUTA tax liability on 100% of each employee's gross annual wages (plus 10% to account for growth) from the prior year, CU significantly overstated the employers' SUTA tax liabilities. For example, CU calculated one employer's total SUTA tax liability for calendar years 2009 and 2010 at \$121,608. Based on the employer's reported taxable wages for 2008 (plus 10% each year for growth), we calculated the employer's total SUTA tax liability for the same period at \$8,018, only 6.6% of UIA's established estimates. In addition, UIA assessed the employer \$18,677 in related interest and penalties, which in itself was 2.3 times the total two-year SUTA tax liability that we calculated for the employer.

CU informed us that it overstated the SUTA tax liability of nonreporting employers to encourage them to contact CU and make payment arrangements. Although CU adjusts an employer's estimated liability to actual when an employer submits a previously unsubmitted contribution report, it is questionable whether this overestimation practice complies with Section 421.15(i) of the *Michigan Compiled Laws*.

RECOMMENDATIONS

We recommend that CU effectively determine if employers remain in business before estimating and attempting to collect employers' unpaid SUTA taxes.

We also recommend that CU accurately estimate employers' unpaid SUTA taxes using the employers' taxable wages.

AGENCY PRELIMINARY RESPONSE

UIA partially agrees. UIA stated that the USDOL's TPS requires that UIA identify employers that are delinquent in filing their tax reports, notify employers of their missing reports, and resolve each missing report issue within 180 days of the delinquency by securing the missing report, determining that the employer is nonliable for the reporting period, or assessing the estimated monetary liability. UIA stated that, when an employer files a missing tax report or notifies UIA that it is out of business, the requirement has been met. Otherwise, as permitted by Section 15(i) of the MES Act, UIA issues a determination of willful neglect and estimates the tax liability for the quarter/year through an automated process. UIA stated that, once it estimates an employer's tax liability, it assesses the employer. UIA indicated that this qualifies as securing the missing tax report under TPS. UIA informed us that, when it estimates a quarter/year and the employer subsequently files the missing report(s) or provides its actual payroll figures, UIA immediately adjusts the estimated liability to reflect the information provided by the employer.

UIA stated that compliance with the first recommendation is not currently attainable because of the large number of the involved accounts (approximately 17,000 per quarter) and the lack of an accurate source that can be used to automate this task. However, UIA informed us that it is researching potential sources to accomplish the automation of this process.

In regard to the second recommendation, UIA stated that it agrees that the 10% "add on" to the gross wage calculation is not reasonable and has been discontinued by directive of the agency director. UIA indicated that it instituted a new estimation process effective November 1, 2011. UIA informed us that the new process will use the actual gross and taxable wages from the same quarter of the prior year's tax report filed by the employer as the wages for the estimated report. UIA stated that this change provides a reasonable and substantiated basis for estimating tax liabilities without overestimating the receivables and also preserves the integrity of the tax rate calculation.

FINDING

6. Security Collateral

UIA did not ensure that applicable reimbursing employers provided UIA with security collateral. As a result, our review identified that UIA lost otherwise collectible reimbursement payments and likely will incur additional losses in the future.

Reimbursing employers reimburse UIA dollar-for-dollar for UI benefits paid to their employees. Reimbursing employers include nonprofit organizations, governmental entities, Indian tribes and tribal units, and others. To secure payment of their reimbursement obligations, Section 421.13a of the *Michigan Compiled Laws* requires nonprofit organizations with more than \$100,000 in annual wages and that elected to be reimbursing employers after December 21, 1989 to provide UIA with security collateral (i.e., a surety bond, an irrevocable letter of credit, or other UIA-approved security). Also, *Michigan Administrative Code* R 421.603 requires all other nonprofit organizations that are delinquent in making reimbursement payments for two consecutive quarters to provide UIA with security collateral equal to 4.0% of the employers' gross annual wages. Similar requirements exist for Indian tribes and tribal units.

As of March 31, 2011, an estimated 1,293 active nonprofit organizations and Indian tribes or tribal units were or could be required to provide UIA with security collateral. We reviewed the reimbursement payment history and security collateral held by UIA as of May 10, 2011 for 20 of these employers. We identified 3 (15.0%) employers that were delinquent in submitting their reimbursement payments for at least two consecutive quarters and for which UIA had not requested and received the required security collateral. The 3 employers had delinquent reimbursement payments totaling \$20,875.

From October 1, 2008 through January 26, 2011, UIA wrote off as uncollectible delinquent reimbursement payments totaling \$642,000 for 5 reimbursing employers. We noted that 1 (20.0%) of the employers submitted its reimbursement payments late during two consecutive quarters and, therefore, should have provided UIA with security collateral totaling an estimated \$91,000. If UIA had requested, received, and used this collateral, it could have significantly reduced the \$430,035 that it wrote off as uncollectible for the employer.

UIA informed us that it did not request the required securities from the 4 employers because it pursued collection of their delinquent payments through other methods. While pursuing collection of the delinquent payments is allowable and recommended, it did not relieve UIA of its responsibility for obtaining security collateral to secure payment of the employers' future reimbursement obligations.

RECOMMENDATION

We recommend that UIA ensure that applicable reimbursing employers provide UIA with security collateral.

AGENCY PRELIMINARY RESPONSE

UIA agrees. UIA informed us that it issued a new Statement of Policy in June 2011 to ensure uniform treatment of reimbursing nonprofit employers and Indian tribes or tribal units with respect to the requirements of Sections 13a and 13l of the MES Act. UIA stated that this policy defines three types of allowable securities, details the criteria that UIA will use in requiring security collateral, and defines when an employer-signed payment plan agreement will replace the security requirement. UIA will convert all active reimbursing employers that are delinquent for two consecutive calendar quarters and failed to provide the required security to "contributing" status effective January 1, 2012.

GLOSSARY

Glossary of Acronyms and Terms

civil judgment	A final court decision from a civil lawsuit often ordering a party to pay a certain sum of money to the other party.
CLEAR	Consolidated Lead Evaluation and Reporting.
contributing employer	An employing unit determined liable to pay unemployment taxes on a quarterly basis to UIA based on an assigned experience rate. Contributing employers are generally for-profit businesses and not-for-profit businesses that did not elect reimbursing status.
CU	Collections Unit.
effectiveness	Success in achieving mission and goals.
efficiency	Achieving the most outputs and outcomes practical with the minimum amount of resources.
FUTA	Federal Unemployment Tax Act.
gross wages	Total wages paid by an employer to workers in a quarter. This includes the cash value of all compensation paid in any medium other than cash, such as meals, lodging, and rent. Only cash wages should be reported for agricultural or domestic services.
internal control	The plan, policies, methods, and procedures adopted by management to meet its mission, goals, and objectives. Internal control includes the processes for planning, organizing, directing, and controlling program operations. It includes the systems for measuring, reporting, and monitoring program performance. Internal control serves as

a defense in safeguarding assets and in preventing and detecting errors; fraud; violations of laws, regulations, and provisions of contracts and grant agreements; or abuse.

IRS	Internal Revenue Service.
levy	To use government authority to impose or collect a tax.
material condition	A reportable condition that could impair the ability of management to operate a program in an effective and efficient manner and/or could adversely affect the judgment of an interested person concerning the effectiveness and efficiency of the program.
MES Act	Michigan Employment Security Act.
notice to withhold	A collection tool used to obtain money via an employer's bank account or accounts receivable.
PACER	Public Access to Court Electronic Records.
performance audit	An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve program operations, to facilitate decision making by parties responsible for overseeing or initiating corrective action, and to improve public accountability.
personal property	Temporary or movable property.
personal property lien	A lien filed with the Secretary of State against the personal property of employers with delinquent SUTA taxes totaling \$3,000 or more.
predecessor	An employing unit that has sold all or part of its assets to another business.

real property	Stationary or fixed property, such as land and buildings.
real property lien	A lien filed with a county register of deeds on the real property of employers with delinquent SUTA taxes totaling \$100 or more. Real property liens create a hold on the sale of all real property owned by an employer in the county in which the lien is filed.
reimbursing employer	An employer who does not pay quarterly taxes based on an assigned experience rate but instead reimburses UIA dollar-for-dollar for the UI benefits paid to the employer's employees. Reimbursing employers are nonprofit organizations that have been granted 501(c)(3) status; hospitals; governmental entities, including cities, counties, schools, and universities; and Indian tribes and tribal units.
reportable condition	A matter that, in the auditor's judgment, is less severe than a material condition and falls within any of the following categories: an opportunity for improvement within the context of the audit objectives; a deficiency in internal control that is significant within the context of the objectives of the audit; all instances of fraud; illegal acts unless they are inconsequential within the context of the audit objectives; significant violations of provisions of contracts or grant agreements; and significant abuse that has occurred or is likely to have occurred.
RU	Reimbursing Unit.
successor	An employing unit that has acquired the organization, trade, business, or 75% or more of the assets of another employing unit.
SUTA	State Unemployment Tax Act.

SUTA dumping	The transfer or acquisition of a trade or business or a portion of a trade or business for the sole or primary purpose of reducing the business's contribution rate and thereby paying less SUTA tax.
SUTA Dumping Detection System (SDDS)	A Web-based database that allows the user to query employer and wage record information for specific types of activity. It provides snapshots of changes in employment, wages, taxes, and benefits charged to employer accounts that have experienced employee movements.
taxable wages	The first \$9,000 of each employee's annual wages.
TEU	Tax Enforcement Unit.
TPS	Tax Performance System.
UCF	Unemployment Compensation Fund.
UI	unemployment insurance.
UIA	Unemployment Insurance Agency.
USDOL	U.S. Department of Labor.

