Compensation

Compensation means all remuneration for services performed by an employee including the cash value of all remuneration paid in any medium other than cash plus certain other payments (hereafter referred to as fringe benefits). For the purpose of this bulletin, compensation for personal services, and compensation as fringe benefits are defined separately.

Compensation includes all wages, salaries, fees, bonuses, commissions, or other payments on behalf of or for the benefit of employees of the taxpayer that is either subject to FIT withholding or specifically excepted under Section 3401(a)-1 of the IRC. (MCL 208.4(3))

Examples of the most frequent excepted remuneration are payments for:

1. Agricultural labor.
2. Services not in the course of employer's trade or business (relating to casual labor).
3. Moving expenses if it is reasonable to believe that the employee will be entitled to a deduction under IRC Section 217.
4. Educational and dependent care assistance if it is reasonable to believe that the employer will be able to exclude such payment or benefit from income under IRC Section 127 or 129.
5. Medical care reimbursement made to or for the benefit of an employee under self-insured medical reimbursement plan.

Compensation includes involuntary tips (i.e., automatic service charges).

Compensation does not include the following

1. Discounts on the price of the taxpayer's merchandise. (MCL 208.4(3)(a))
2. Payments to independent contractors. (MCL 208.4(3)(b))
3. Payments to state and federal unemployment compensation funds. (MCL 208.4(3)(c))
4. Employer portion of payments to FICA. (MCL 208.4(3)(d))
5. Payments, including self insurance payments, for worker compensation insurance. (MCL 208.4(3)(e))
6. Payments under health and welfare and noninsured benefit plans for the benefit of persons who are Michigan residents and payment of fees for the administration of health and welfare benefit plans. The following amounts are not compensation:
   a. 5% for tax years that begin after December 31, 2003 and before January 1, 2005.
   b. 20% for tax years that begin after December 31, 2004 and before January 1, 2006.

c. 40% for tax years that begin after December 31, 2005 and before January 1, 2007.
d. 50% for tax years that begin after December 31, 2008.

Employee/Employer

The compensation addback is applicable to an "employer" in the amount of payments made to or for the benefit of an "employee". The identification of the employer and employee is of utmost importance to determine if a payment is added back under Section 4 and on whose tax return the payment is added back.

> "Employee" means an employee as defined in section 3401© of the internal revenue code. A person from whom an employer is required to withhold for income tax purposes shall prima facie be deemed an employee. (MCL 208.5(1))
>
> "Employer" means an employer as defined in section 3401(d) of the internal revenue code. A person required to withhold for federal income tax purposes shall prima facie be deemed an employer. (MCL 208.5(2))

Generally, the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer.
In determining "employees of the taxpayer", the Department adopts IRS Regulation 31.3401(c)-1, relating to the definition of employee, and 31.3401(d)-1 (a)-(d), relating to the definition of employer. The definition of employer in paragraphs (e), (f), and (g) of IRS Regulation 31.3401(d)-1 are designed to meet special or unusual situations and are not intended to depart from the legal relationship of employer and employee.

Compensation for personal services is reported in the taxable year in which such payments are made. As a general rule, compensation is the amount reported as "wages subject to withholding" on Form 941, employers Quarterly Federal Tax Return:

1. If the taxable year does not correspond with the 941 quarterly reporting this amount must be adjusted to report only compensation paid within the taxable year.
2. If the person for whom the services are rendered and the person who is considered the employer under IRS Regulation 31.3401(d)-1 (e), (f), and (g) are not the same, the amount from the federal form 941 must be adjusted so the compensation for such services is reported by the person for whom such services are rendered in a legal relationship of employer and employee.
3. Remuneration excepted from FIT withholding must be added to this amount.

4. Capitalized compensation and compensation reported on a completed contract basis for federal income tax purposes are included as compensation in taxable year in which such payments are made.

Compensation also includes payments:

1. To individuals not currently working (payments to individuals for past services);
2. To dependents and heirs of individuals because of services rendered by those individuals;
3. To pension, retirement, or profit sharing plans; and
4. Contributions to the following employee's stock ownership plans including transfers of securities are compensation whether a deduction or a credit is taken for FIT purposes.
   a. Employees Stock Ownership Plans (ESOP).
   b. Tax Reduction Act Stock Ownership Plan (TRASOP).
      i. Cost of maintaining "in house" pension, retirement, profit sharing, or self-insurance programs is compensation (relating to legal and accounting cost).
      ii. Contributions on the employee's behalf to an individual retirement account (IRA), individual retirement annuity or retirement bond.
5. Fringe benefit insurance for which employees are the beneficiaries.
   a. it is not necessary that the services by the employee be continuing at the time the payment for insurance is made.

Payments of fringe benefits are reported as compensation on a cash or accrual basis consistent with the taxpayer method of accounting for FIT purposes.

1. Fringe benefits which are credited to capital accounts are included as compensation when credited to such accounts.
2. If a taxpayer reports on a completed contract basis for federal income tax purposes, fringe benefits are included as compensation on either a cash or accrual basis consistent with the taxpayer method of accounting.

Compensation is by far the largest component of the Single Business Tax base. Some taxpayers have successfully reduced their Single Business Tax liability by reconstructing and/or utilizing alternative means of compensation.

The specific issues are in two basic areas. The use of a temporary employment agency for employment services, and the use of leased employees obtained from a professional employment organization (PEO) utilizing an employee leasing company.

Temporary Employment Agency

Many taxpayers, in an effort to reduce cost and more specifically to reduce the fixed cost element of compensation, have utilized the services of temporary employment agencies. The fees paid to these agencies by the taxpayer would not be considered compensation and would not be considered an addback for Single Business Tax purposes. The temporary employees are employees of the agency and not of the taxpayer who hires them from the agency. The temporary employment agency would be required to addback the compensation paid to these temporary employees

notwithstanding the fact that the services that they are providing are provided to the taxpayer.

Professional Employment Organization

There are a large number of organizations operating within Michigan and nationally which provide leased employee services. This appears to be a growing industry.

These organizations provide the following services to their clients: recruiting and screening, personnel administration, employee relations, payroll administration, liability management, regulatory compliance, unemployment administration, workers compensation, liability control services, claims management, benefits design, benefits administration, and a comprehensive benefits program. Usually these organizations can offer these services at a lower cost from which the taxpayer can provide or purchase these services individually.

The management fee which the leased employee company charges to the taxpayer is not a Compensation Addback for Single Business Tax purposes. The employees are employees of the employee leasing company and not the taxpayer notwithstanding the fact that the services are provided to the taxpayer. The leased employee company would be required to addback the compensation for their employees.

Employee Leasing Company (ELC)

This type of tax planning is much more complicated and quite a bit riskier. The Department of Treasury auditors have set up audits knocking out the ELC. Many of these audits are pending appeal and are involved in litigation.

In a typical ELC, a group of related entities will establish a separate entity which will handle all payroll, payroll taxes, and other related employment responsibilities. The Single Business Tax savings evolve from the fact that the compensation is removed completely from the operating companies and placed in the ELC. The ELC normally would file under the 50 percent gross receipts method and thereby slice 50 percent of the compensation from the total tax liability of the combined group of entities.

Oftentimes, an ELC operates in much the same way as a PEO. The major difference between the two is the fact that the ELC is a related entity. Because of the absence of a true arms length transaction, the scheme is open for abuse and for adjustment by Department of Treasury auditors.

In order to make this tax planning technique work, it is very important that the ELC be a legal entity, a corporation, a partnership, etc.; and that all the necessary paperwork be filed and completed. Secondly, it is very important that the ELC operate like a business engaged in for profit. This entity should have a chart of accounts, a general ledger, and should file a separate tax return including separate payroll tax returns. The separate entity should have its own checking account. The third requirement is that of a management contract. The ELC should enter into a management contract with the operating companies. The management contract should specify the services to be

provided and how the management company will be reimbursed for providing such services. The reimbursement should also include a profit element.

Before a Single Business Taxpayer creates an ELC, they should establish and document good sound business purposes for going in this direction other than Single Business Tax savings. If done properly, the ELC can save the taxpayer Single Business Tax but can also save the taxpayer time and money in other areas.

Mid America Management Corp. v. Department of Treasury

Michigan Court of Appeals, No. 85245, July 21,1986, 153 Mich App 446, 395 NW2d 702, affirming Michigan Tax Tribunal, May 16, 1985

A corporate property manager, Mid America Management Corp, engaged primarily in the management of apartment complexes and shopping centers was not required to include compensation paid to on-site employees of the project owners in the corporation's single business tax base.

At issue was whether or not the management company or the project owners were the common-law employers of the employees. A common law relationship exists between an employer and employee when the person for whom the services are performed has the **exclusive** right to control and direct the individual who performs the services, not only as to the result to be accomplished but also as to how the result is accomplished. As outlined in a management agreement, the property manager had the authority to hire, fire and supervise employees on a daily basis. The wages were paid by the property manager who reported all withholdings to the governmental agencies. Per Single Business Tax Act Section 5 (MCL 208.5(1)) and 208.5(2), an employee is a person from whom an employee is required to withhold for federal income tax purposes and shall prima facie be deemed an employee. Therefore, the management company included the compensation on their Single Business Tax return. However, the project owner also had such rights over the employees as well as the hiring, firing and supervising of the property manager. If a conflict arose over policies or procedures, the project owner's decisions would control the matter.

The Department took the position that Mid-America is the employer of the on-site employees because Mid America controls the daily activities previously mentioned. Therefore, according to Treasury, the entire compensation paid should be included in the tax base of Mid America.
The Michigan Tax Tribunal agreed with the Department of Treasury, however, Mid America Management appealed to the Michigan Court of Appeals. On appeal, the decision was overturned and the project owner was determined to be the common law employer and required to include the compensation of the employees on their single business tax return.

Show Biz Pizza Time, Inc. v. Department of Treasury
Michigan Tax Tribunal, No. 120387, September 23, 1991.

A non-Michigan corporation engaged in the business of managing family-style restaurant facilities was required to include in its adjusted single business tax, pursuant to Section 208.9(5), the payroll of employees in the restaurants that it operated as a joint venture or partner (JV/P restaurants) and the restaurants that it managed but in which it did not have an equity interest (managed restaurants).

Again, the issue examined was who is the common law employer with the **exclusive** right to hire, fire and supervise the employees. Show Biz reported all employees withholding to the governmental agencies as well as controlled the hiring, firing, supervising and possessed sole responsibility for directing the activities of the employees. The actual owners of the managed restaurants and JV/P participants did not, on any occasion, hire, fire or direct the activities of persons employed at the restaurant sites.

The Tribunal held that these persons qualified as employees of Show Biz because they had the **exclusive** right to hire, fire and control them, paid them, and withheld and remitted income tax monies from their wages. Further, the management and JV/P agreements entered into by the taxpayer memorialized the fact that persons managed by the taxpayer were its employees and not those of the joint venture, the restaurant owner, or the partnership.
Bandit Industries, Inc. v. Department of Treasury
Michigan Circuit Court of Claims, No. 99-17260-CM, September 7, 2000

A Michigan corporation in the business of manufacturing wood chipping machinery sets up an employee leasing company. The employee leasing company fails the control test for entities under common control thereby qualifying for the small business credit. All the prior employees of the operating company, including officers, were subsequently employed by the employee leasing company and leased back to the operating company for a fee. The arrangement was adequately documented in the form of an employee leasing agreement.

After a few years, the gross receipts of the employee leasing company grew to the point where it may have been disqualified for the small business credit. Bandit then set up another employee leasing company and transferred the officers to that company. Both employee leasing companies qualified for the small business credit.

The Department of Treasury audited Bandit Industries and also reviewed the two employee leasing companies. They accepted the first employee leasing company without adjustment. On the second employee leasing company, the auditors moved only the officer's compensation to the tax return of the operating company, Bandit Industries.

The case was appealed to the Michigan Tax Tribunal. The issue was "whether the officers of Bandit were "employees" of Bandit such that their compensation should be added to Bandit's tax base". The court ruled in favor of the Department of Treasury. "Under section 3401(c) of the Internal Revenue Code ("IRC"), an employee is defined as …the term "employee" also includes an officer of the corporation. Based on these definitions, …Bandit's officers must be employees of Bandit, despite the fact that they

were leased from another company and paid their compensation from another company." The Treasury's position, also supported by the court was based on the intent of the SBTA to tax value added to a product. To the extent that the officers participated in Bandit's business activity and were compensated, their compensation must be recognized in Bandit's SBT base.

In Letter Ruling 2002-04, Officer Compensation, the Department ruled that all compensation paid to a corporation's officers or an LLC's managers must be included in the corporation's or LLC's SBT base whether or not the employees are leased from an employee leasing company.

Public Act 603 of 2002 Overturns Bandit Industries

House Bill 5403 (PA 603) was signed by the governor in December of 2002 to be effective for tax years that begin after December 31, 2003. The new Act provides that the compensation add back for payment by a Professional Employment Organization (PEO) to the officers and employees of an entity whose employment operations are managed by the PEO belongs on the SBT return filed by the PEO and not the SBT return for the entity utilizing the services of the PEO employees. The bill reverses the findings of the Michigan Circuit Court of Appeals in *Bandit Industries* and the Department of Treasury's interpretation of current law that compensation of officers cannot be included in the SBT base of the company for which the officers provide services.

The Act defines a "professional employer organization" as "an organization that provides the management and administration of the human resources and employer risk of another entity by contractually assuming substantial employer rights, responsibilities, and risk through a professional employer agreement that establishes an employer relationship with the leased officers and employees assigned to the other entity by doing all of the following:

1. Maintaining the right of direction and control of employees work, although this responsibility may be shared with the other entity.
2. Paying the wages and employment taxes of the employees out of its own accounts.
3. Reporting, collecting, and depositing state and federal employment taxes for the employees.
4. Retaining the right to hire and fire employees."
   (MCL 208.4(4))

Our firm provides the information in this whitepaper for general guidance only, and does not constitute the provision of legal advice, tax advice, accounting services, investment advice, or professional consulting of any kind. The information provided herein should not be used as a substitute for consultation with professional tax, accounting, legal, or other competent advisers. Before making any decision or taking any action, you should consult a professional adviser who has been provided with all pertinent facts relevant to your particular situation. Tax articles in this whitepaper are not intended to be used, and cannot be used by any taxpayer, for the purpose of avoiding accuracy-related penalties that may be imposed on the taxpayer. The information is provided "as is," with no assurance or guarantee of completeness, accuracy, or timeliness of the information, and without warranty of any kind, express or implied, including but not limited to warranties of performance, merchantability, and fitness for a particular purpose.