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SBT TAX BASE: PROFESSIONAL EMPLOYER ORGANIZATIONS

House Bill 5403 as enrolled
Public Act 603 of 2002
First Analysis (1-15-03)

Sponsor: Rep. Gary A. Newell
House Committee: Tax Policy
Senate Committee: Finance

THE APPARENT PROBLEM:

According to information from the National Association of Professional Employee Organizations, this kind of organization (called a PEO) "is a company [that] contractually assumes and manages critical human resource and personnel responsibilities and employer risks for its small and mid-sized businesses by establishing and maintaining an employer relationship with worksite employees". Put another way, a business will contract with a PEO to provide it with staff or employees; the PEO and client will function as co-employers. As co-employers, the NAPEO says, the PEO and the client company each has a right to hire and fire and each has a right to direct and control employees: "The PEO directs and controls worksite employees in matters involving human resource management and compliance with employment laws, and the client company directs and controls worksite employees in manufacturing, production, and delivery of its products and services". (The quotations are from information on the web site of the National Association of Professional Employee Organizations.)

In explaining why a company would want to do this, the NAPEO says, "Businesses today need help managing increasingly complex employee related matters such as personnel management, health benefits, workers' compensation claims, payroll, payroll tax compliance, and unemployment insurance claims. Businesses contract with a PEO to assume these responsibilities, which then allows the client to concentrate on the revenue-producing side of its operations". This differs from temporary staffing services in that, according to industry reports, "a PEO contractually assumes and manages employer responsibilities for all or a majority of a client's workforce", whereas temporary staffing services place workers into companies as supplements to the workforce, to cover such things as temporary absences, seasonal changes in workload, or temporary skill shortages. A PEO pays the employee wages and reports and collects federal and state employment taxes. The employees are sometimes referred to as "leased employees", although the NAPEO does not like the term.

An issue has arisen over how to treat the compensation paid to "leased officers" for purposes of Michigan's unique single business tax. One component of the single business tax base is the compensation paid by a firm to its employees, officers, and directors. Generally speaking, the compensation paid to co-employees is considered to be part of the PEO single business tax base rather than the tax base of the client company, but the Department of Treasury sees the compensation of company officers as part of the client company's tax base. The Michigan Court of Claims, in <u>Bandit Industries, Inc. v Michigan Department of Treasury</u>, agreed with state tax officials in litigation over how to treat leased company officers. This, obviously, had the effect of increasing the tax liability of the client company. A complicating factor, according to tax specialists, is that service oriented firms such as PEOs are said to commonly use an alternative method of computing the single business tax, a method based on gross receipts rather than on the standard SBT tax base. Since the amount paid to a PEO by a client company (some of which would be used to compensate officers) is counted as part of gross receipts, the argument was made that, under the state's interpretation, this officer compensation is taxed twice, once as part of the PEO's tax base and again as part of the client company's tax base. Legislation was subsequently introduced to address the issue of the tax treatment of compensation for company officers.

THE CONTENT OF THE BILL:

One component of the tax base on which a firm determines its single business tax liability is the compensation it pays to officers and employees. The bill would amend the Single Business Tax Act to specify that, for tax years after December 31, 2003, compensation paid by a professional employer organization to the officers and employees of an entity whose employment operations are managed by the professional employer organization would be considered to be compensation in the tax base of the professional employer organization. Such compensation would not be included as compensation in the tax base of the entity whose employment operations were managed by a professional employer organization.

The term "professional employer organization" would be defined in the bill to mean 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 or employers assigned to the other entity by 1) maintaining the right of direction and control of employees' work, although this responsibility may be shared with the other entity; 2) paying 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; and 4) retaining the right to hire and fire employees.

MCL 208.4

BACKGROUND INFORMATION:

In the case that led to this legislation, Bandit Industries, Inc. v Michigan Department of Treasury, the department determined during an audit of the company that Bandit had three "leased officers" who should be considered employees of Bandit rather than employees of the PEO from whom they were "leased". All of the employees working for Bandit were leased from a PEO. Among these were three employees who also served as Bandit's corporate officers. The department determined that because these three persons were officers compensated for services performed for the benefit of Bandit, they were employees of Bandit under the definitions found in the Single Business Tax Act (and derived from the federal Internal Revenue Code). As such, the compensation paid to the officers should be included in the SBT tax base. The company argued that this compensation should not be included in the tax base because the compensation was paid by the PEO; the three officers were employees of the PEO leased to Bandit; a specific exemption (the "minor services" exemption) in the federal Internal Revenue Code applied that allowed the officers not to be treated as employees, as the IRC would otherwise require; and that the compensation was paid to the three persons for the services they performed as employees and not for the miniscule amount of time spent as officers.

The Department of Treasury's case included the argument that the SBT was a tax on the value added by a firm in producing a product and that the officers added to the firm's value because they were responsible for running it. The department also said that the time the three persons spent as officers had to be taken into account since it was impossible to distinguish between time spent as an officer and time spent as an employee. The department also rejected the use of the "minor services" exemption because that requires the officers not receive compensation (which they did) and because the exception is contrary to the intent of the SBT as a value added tax. Generally speaking, the Michigan Court of Claims saw the dispute as whether the "minor services" exemption applied in this case. It agreed with the department that the exemption should not apply and said that the officers of Bandit should be considered employees of Bandit under the definition of employer in the federal Internal Revenue Code and consistent with the purpose of the SBT to tax the value added to Bandit by its officers.

(The information in this section is derived from the published court decision from the Michigan Court of Claims dated 9-7-00.)

FISCAL IMPLICATIONS:

The Senate Fiscal Agency reports that the bill would reduce single business tax revenues by less than half of a million dollars annually beginning in fiscal year 2003-2004. The fiscal impact would be larger, says the SFA, "if many businesses that use PEOs did not have a different interpretation of current law and were not already treating compensation paid to officers like the compensation paid to all other employees, as they apparently are doing". The loss of revenue will occur because the companies for whom the officers work tend to calculate SBT liability using the standard value added computation, which includes compensation paid to employees and officers, while the PEOs tend to use the alternative gross receipts calculation, which is based on gross receipts and not compensation paid to employees and officers. This means, the bill would lower tax liability for client companies who otherwise would include officers' compensation in their tax base without increasing tax liability for PEOs. (SFA analysis dated 12-10-02)

ARGUMENTS:

For:

The bill would clearly spell out how the compensation of officers (and employees) would be treated for the purpose of calculating single business tax liability when the officers and employees were part of a contractual arrangement between a professional employer organization and a client company. The bill would specify that, after December 31, 2003, this compensation would be considered to be part of the SBT tax base of the PEO and not of the client company. This, in essence, would reverse the finding of the Michigan Court of Claims in a recent case over this issue that the compensation of company officers should be included in the SBT tax base of the client company and not of the professional employer organization. It also reverses the position of the Department of Treasury. Business representatives say that this bill will remove uncertainty and confusion for taxpayers; provide consistency in the treatment of employees under PEO arrangements, with officers treated in the same way as all other employees; and interpret the law as it was originally intended to be interpreted.

Response:

The single business tax is a "value added" tax; it attempts to tax the value a firm adds to a product as it produces it. The officers of a firm, whether leased or not, add value to that firm in a special way, since they are operating the firm. If a firm has no employees of its own and no officers of its own, what is it? The Department of Treasury's interpretation of the way in which so-called leased officers should be treated under the SBT was upheld by the state's Tax Tribunal and by the Court of Claims and should not be cast aside by the legislature.

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■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.