

Legislative Analysis



SBT SMALL BUSINESS CREDIT: REQUIRE CONSOLIDATED RETURNS FOR CERTAIN PROFESSIONAL EMPLOYER ORGANIZATIONS

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House Bill 5323 (Substitute H-2)
Sponsor: Rep. Lorence Wenke
Committee: Tax Policy
First Analysis (5-11-04)

BRIEF SUMMARY: The bill would amend the Single Business Tax Act to require certain professional employer organizations to file a consolidated return as a condition of claiming the small business credit provided under the act.

FISCAL IMPACT: The bill would increase SBT revenue, all of which accrues to the General Fund/General Purpose, by a minimal amount. (The Department of Treasury estimate is \$3 million to \$4 million annually.)

THE APPARENT PROBLEM:

A professional employer organization (PEO) is a company that contractually assumes and manages critical human resource and personnel responsibilities and employer risks for, generally speaking, small and mid-sized business. A business will contract with a PEO to provide it with staff or employees, and both function as co-employers. Each has control over these employees in terms of hiring and firing; the client company directs the day-to-day work of the employee (just like any other employer-employee relationship), but the PEO is responsible for the human resource management, such as payroll, worker's compensation, and health benefits.

In explaining why a company would want to do this, the National Association of Professional Employer Organizations states, "[b]usinesses today need help managing increasingly complex employee related matters such as health benefits, workers' compensation claims, payroll, payroll tax compliance, and unemployment insurance claims. They contract with a PEO to assume these responsibilities and provide expertise in human resources management. This allows the PEO client to concentrate on the operational and revenue-producing side of its operations." This differs from temporary staffing services in that those businesses place workers into companies as supplements to the workforce, such as covering temporary absences, seasonal workload changes, and temporary skill shortages. Ultimately, the PEO pays the employee wages and reports and collects federal and state employment taxes.

Last session, the Single Business Tax Act was amended by Public Act 603 of 2002 to specify that the compensation paid by a PEO to an employee of the client would be considered to be compensation in the tax base of the PEO, not the client. The client

would still be responsible for any tax liability, including the SBT, but the compensation paid to its “employees” by a PEO are not used to determine its SBT base.

The changes made by Public Act 603 took effect for tax years beginning after December 31, 2003, and in that short period of time, an apparent problem with certain PEOs has surfaced, as it is alleged that companies have employed various tax avoidance tactics to reduce their single business tax liability.

Specifically, critics say that some large PEOs have broken into smaller PEOs, which enables them to claim the small business credit many times over and greatly reduce their SBT liability. While many PEOs will break into three or four smaller entities based on a particular specialization, such as a PEO that only provides clerical staff, many other PEOs will break into a dozen or so PEOs, ostensibly just to reduce their SBT liability. While such PEOs may market themselves as being one PEO (and for the most part, they are one large PEO), they claim to be, for tax purposes, several small PEOs. In addition, PEOs typically charge the client a fee based, in part, on the additional SBT liability the PEO assumes. Critics say some unscrupulous PEOs charge a fee based on the additional SBT liability, but find ways to further reduce that liability, which allows them to keep the difference. This, it is alleged, provides these PEOs certain marketplace advantages over competitor PEOs who are faithfully following the intent of the law and do not employ similar tax avoidance strategies. Legislation has been introduced to ensure that only legitimately small PEOs can take the small business credit.

THE CONTENT OF THE BILL:

The Single Business Tax Act prohibits certain entities from taking the small business credit provided under the act unless the business activities of those entities are consolidated. These entities include an affiliated group, a controlled group of corporations (as defined under the federal Internal Revenue Code and related regulations), and an entity under common control (as defined under the federal Internal Revenue Code). The bill would also prohibit a “related operating entity” from taking the small business credit unless its business activities are consolidated, for tax years beginning after December 31, 2004.

The bill would define “related operating entity” to mean a *professional employer organization* (PEO) that is not a *captive provider* and that (1) is more than one percent owned by another PEO or is an entity that owns more than one percent of another PEO; (2) owns more than one percent of another PEO; or (3) markets itself under a common name with another PEO or receives payroll, human resources, administrative, or similar services from a company to provide those services to other PEOs.

The bill would define “professional employer organization” to mean an organization that provides 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 employees assigned to the other entity in certain specified

ways, including maintaining the right of direction and control of employee's work (although this can be shared with the other entity); paying wages and employment taxes out of its own accounts; reporting, collecting, and depositing state and federal employment taxes; and retaining the right to hire and fire employees.

A "captive provider" would be defined to mean a professional employer organization that limits itself to providing services and employees to only one client and its subsidiaries and affiliates, and does not provide its services to other clients that do not share an ownership relationship with it.

The small business credit is available to firms whose gross receipts do not exceed \$10 million and whose adjusted business income does not exceed \$475,000, provided that no officer or owner receives more than \$115,000 as compensation or as a share of business income. Businesses that qualify for the small business credit can use one of two methods of computing their SBT liability: (1) by using the standard small business credit calculation of dividing adjusted business income by 45 percent of the tax base; or (2) by using two percent of adjusted business income. For consolidated returns, the small business credit is determined as though the member corporations file as one corporation, except that the shareholder and officer compensation disqualifiers are computed on a separate return basis.

The small business credit, which is limited to 100 percent of the tax liability, is based on the ratio of "adjusted business income" to 45 percent of the tax base, so that the credit equals $[1 - (\text{ABI} / 45\% \text{ of tax base})] \times \text{tax liability before the credit}$. In essence, the tax liability after application of the small business credit is the product of (1) the tax liability before the credit, and (2) the quotient of adjusted business income and 45 percent of the tax base.

MCL 280.36

ARGUMENTS:

For:

Proponents of the bill believe that the creative tax avoidance practices employed by certain large PEOs undermine true competition within the industry and hinder the ability of the state to collect single business taxes. Critics charge that by charging a fee based on the additional SBT liability, then restructuring their operations, claiming the small business credit to reduce their SBT liability, and keeping the difference, certain PEOs unfairly gain advantage in the marketplace over other PEOs. This creates an uneven playing field within the industry that stifles competition and hinders the growth of the industry within the state.

The bill solves this problem in state tax law by requiring a professional employer organization, as a condition of claiming the small business credit, to consolidate its business activities if at least one percent of it is owned by another PEO or it itself is an entity that owns at least one percent of another PEO; if it itself owns more than one

percent of another PEO, or markets itself under a common name with another PEO or receives services from a company to provides those services to other PEOs. Current law requires an affiliated group, a controlled group of corporations, and an entity under common control to file a consolidated return as a condition of claiming the small business credit. When a PEO breaks into a dozen smaller PEOs, it no longer fits the criteria for being an affiliated group, controlled group of corporations, or an entity under common control, thereby allowing each small PEO to file a separate return with a separate small business credit.

The current version of the bill continues to allow legitimately small businesses to take the small business credit, and prohibits large businesses, through the use of creative tax planning practices, from breaking into small entities and taking the small business credit many times over.

Against:

Opponents of the bill note that the bill is premised on an *allegation* that certain “unprincipled” tax strategies are occurring. There has been no finding that certain PEOs are acting in a manner inconsistent with the Single Business Tax Act. Moreover, it is certainly debatable that the alleged activities are a means of avoiding SBT liability, as all taxpayers take advantage of whatever tax benefits afforded to them. In this regard, the bill punishes certain PEOs for effective tax management practices that are well within the bounds of the Single Business Tax Act.

POSITIONS:

The Department of Treasury supports the bill. (5-5-04)

Among the companies that have indicated support for this proposal to the House Committee on Tax Policy are Kelly Services, Administaff, Presidion Solutions, and ADP Total Source. (Meetings on 4-21, 4-28, and 5-5)

Among the companies that have indicated opposition to the committee are Orbis, Source HR, Employees Only, Staffco Services, Human Capital, Axios Inc, Administrative Staff Leasing, EA Services, and Genius Solutions. (Meetings on 4-21, 4-28, and 5-5)

The Small Business Association of Michigan opposes the bill (5-6-04)

The National Federation of Independent Business, Michigan opposes the bill. (5-6-04)

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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.