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STATE AND LOCAL TAX NEWSLETTER

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Was a Statutory Employee Subject to the Single Business Tax (SBT)? Is a Statutory Employee Subject to the Michigan Business Tax (MBT)?

GRAND RAPIDS, MI – Monday, July 14, 2008 – The term “statutory employee” is a federal income tax term. For federal income tax purposes, a “statutory employee” is a common law employee whose wages are subject to federal payroll taxes (FICA and FUTA). However, by special provision, the wages paid to a “statutory employee” are not subject to federal income tax withholding. The “statutory employee” reports the Form W-2 wages on Schedule C and is allowed to deduct ordinary and necessary business expenses.

The Michigan Department of Treasury (Treasury) has considered a “statutory employee” subject to the SBT if gross receipts exceed \$350,000. The Discovery Division is working on several “statutory employee” cases for SBT purposes. Our office is handling two of the appeals. The following discusses both the SBT and MBT issues relating to “statutory employees.”

Single Business Tax

The legal argument for why a “statutory employee” should be exempt from the SBT is found in the definition of “business activity” in the SBT Act (SBTA).

(2) “Business activity” means a transfer of legal or equitable title to or rental of property, whether real, personal, or mixed, tangible or intangible, or the performance of services, or a combination thereof, made or engaged in, or caused to be made or engaged in, within this

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state, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or indirect, to the taxpayer or to others, but shall not include the services rendered by an employee to his employer, services as a director of a corporation, or a casual transaction. Although an activity of a taxpayer may be incidental to another or other of his business activities, each activity shall be considered to be business engaged in within the meaning of this act. (Underlined emphasis added)
[MCL 208.3(2)]

It is clear from the plain wording of the law (SBTA) that compensation paid for services rendered by an employee to an employer is not subject to the SBT. Therefore, the taxpayer is not subject to the SBT by reason of the compensation paid to him or her as a “statutory employee”.

The SBTA further defines “employee” and “employer” as follows:

(1) “Employee” means an employee as defined in section 3401(c) of the internal revenue code. A person from whom an employer is required to withhold for federal income tax purposes shall prima facie be deemed an employee. [MCL 208.5(1)]

(2) “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)]

Please note that the law specifies that “to withhold for federal income tax purposes” is only “prima facie” evidence of an employer/employee relationship. The SBTA does not state that the failure “to withhold for federal income tax purposes” negates the employer/employee relationship and thereby subjects the taxpayer to the SBT.

The Federal Internal Revenue Code (IRC) in Section 3401(d) [26 USC 3401(d)] states “the term “employer” means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that –

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(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term “employer” ... means the person having control of the payment of such wages ...”

For a “statutory employee”, the employer has complete control of the payment of wages to the taxpayer for the services rendered to and on behalf of the employer.

The most accurate and clear direction on the employer/employee distinction comes from the Michigan Court of Appeals decision in *Mid America Management Corporation v Michigan Department of Treasury* (153 Mich App 446, 460; 395 NW2d 702 1986). The court stated that “an individual is an employee for federal employment tax purposes if he has the status of an employee under the usual common-law rules applicable in determining the employee-employer relationship.”

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 Michigan Department of Treasury has a long-standing policy of adopting Internal Revenue Service 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 Michigan Court of Appeals in an unpublished opinion in *Earl Samuels v Department of Treasury* (Court of Appeals, Docket No. 230658, February 18, 2003) ruled in a similar situation involving a “statutory employee” that Earl Samuels was not an employee of Aetna Insurance Company. However, there is a very clear distinction between the Samuels case and the cases we are handling. In *Earl Samuels*, “plaintiff presented no testimony, affidavits, or exhibits sufficiently demonstrating an employee-employer relationship with Aetna.” The court ruled “In light of the

emphasis on federal income tax withholding in MCL 208.5 and in light of plaintiff's failure to present sufficient evidence of an employee-employer relationship with Aetna, we conclude that the Tax Tribunal's decision to uphold the SBT assessment was authorized by law ..."

In our cases, the taxpayer is presenting substantial evidence to demonstrate the employer-employee relationship with the employer. In SBTA Sections 5(1) and 5(2), the withholding of federal income tax is only prima facie evidence that an employer/employee relationship exists. Michigan law does not state that the failure to withhold federal income taxes voids the existence of an employer/employee relationship. The court has left open a facts and circumstances determination in the absence of federal income tax withholding.

MICHIGAN BUSINESS TAX

It might be expected that Treasury might also treat a "statutory employee" as subject to the MBT. In the definition of "business activity", Section 105(1) [MCL 208.1105(1)] excludes "services rendered by an employee to his or her employer..." The Section 109(1) definition of "employee" and the Section 109 (2) definition of "employer" are identical to the SBTA definitions of "employee" and "employer". [MCL 208.1109]

The MBT issue, though similar to the SBT issue, has a few different twists. If indeed, a 'statutory employee' is subject to the MBT, then the taxpayer risks exposing income from personal investment activities (dividends, interest, royalties and capital gains) if the assets constitute an integral part of the trade or business or if the income is derived from the active conduct of a trade or business. Furthermore, the "unitary business group" provisions can complicate matters even more. If the "statutory employee" is included in a "unitary business group" by virtue of satisfying both the control test and one of the two relationship tests, then the personal portfolio items and the "statutory employee" wages could be included in a combined MBT return, even if less than \$350,000.

The MBT issues for a statutory employee may be a significant reach or extension of the statutory provisions. However, it is possible. The "statutory employee" should make an effort now to segregate and separate the personal investment activity and assets from the "statutory employee" activities. Furthermore, the "statutory employee" should now collect documentation that they

are indeed an employee.

Stay tuned for more news and follow the [MichiganStateAndLocalTaxBlog](#) for information as it becomes available. If you have any questions, please go ahead and contact me. I will be happy to be of assistance.

Sincerely,

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