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MICHIGAN TAX LAWYER

SBM State Bar of Michigan | TAXATION SECTION

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The MICHIGAN TAX LAWYER is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. THE MICHIGAN TAX LAWYER is published three times each year —September (Fall), January (Winter), and May (Summer). Features include the Section's Committee Reports, news of Section events, feature articles, and Student Tax Notes.

Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. The Taxation Section web address is www.michigantax.org. If you have suggestions or an article you wish to have considered for publication, please contact Marla S. Carew, mscarew@varnumlaw.com, 39500 High Pointe Blvd, Ste 350 Novi, MI 48375.

SUBSCRIPTION INFORMATION

Any member of the State Bar of Michigan may become a member of the Section and receive the MICHIGAN TAX LAWYER by sending a membership request and annual dues of $30 to the Taxation Section, State Bar of Michigan, 306 Townsend Street, Lansing, MI 48933. In addition, any person who is not eligible to become a member of the State Bar of Michigan, and any institution, may obtain an annual subscription to the MICHIGAN TAX LAWYER by sending a request and a $33 annual fee to the Taxation Section at the aforementioned address.

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TAXATION SECTION

March 1, 2012

As we approach the halfway point of this fiscal year, the Section's business activity is accelerating.

Preparations for the **25th Annual Tax Conference** at The Inn at St. John's in Plymouth are in full swing. Featured among the 15 speakers are **Nina E. Olson,** the National Taxpayer Advocate; **Stefan F. Tucker** of Venable, LLP in Washington, D.C.; and **Peter D. Dugas** of Clark Hill's Washington, D.C. office. This year we have added an optional dinner event in celebration of the Conference's 25th anniversary. Check our website, www.michbar.org/tax, for more details.

Policy issues continue to require more of our attention. Recent circulation of a draft Michigan "offer in compromise" bill gives new hope to our long-term efforts to help bring this about. New policy and position statements on three different Michigan tax issues have recently been adopted: Michigan Corporate Income Tax apportionment, contingent fee audit practices (particularly in the unclaimed property area), and retroactive tax legislation. Policy statements adopted by the Section Council are posted on the website's "Public Policy Developments" page.

In January we created a seventh standing committee, the **Young Tax Lawyers Committee**. The Committee's purpose is to attract young lawyers to tax practice and support their development by creating opportunities for education, experience, social networking and coaching from established practitioners. Committee Chair Stephanie Teitsma is busy planning a schedule of events.

And speaking of our committees, we have a full calendar of committee meetings scheduled for the rest of the year. Each committee holds two or three meetings featuring timely presentations on topics of interest to each practice area. See the "Calendar of Events" and "Committee Meetings" website pages for details.

The Section Council is working hard to support you in your tax practice. We hope you'll take full advantage of these opportunities, and let us know how we're doing!

Sincerely,

Warren J. Widmayer
Chairperson

REPORT OF THE BUSINESS ENTITIES COMMITTEE

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The Business Entities Committee hosted a presentation by Bob Gordon of Twenty-First Securities Corporation (New York) on Friday, February 3, 2012, at Honigman's Detroit office. The topic was "Recent Developments in Financial Products Taxation." The presentation included analysis of the IRS' position on an "option" written over a managed account and the recent decision in the Anschutz case, involving a variable prepaid forward contract with a share lending agreement.

REPORT OF THE STATE & LOCAL TAX COMMITTEE

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The SALT Committee is cohosting a property tax petition filing season kick off mixer with the SALT Committee of the State Bar's Real Property Law Section. This event will be held on Thursday, March 8, 2012, at 4:00 p.m. at Rosie O'Grady's in Ferndale. Rather than having a formal program, we will meet for appetizers and refreshments to mingle, network, and share tips and stories as we head into the 2012 tax season. Please contact Jackie Cook to RSVP to this event.

Save the date for the SALT Committee's Annual Lansing Meet and Greet between state tax practitioners and government officials. The 2011 event was well attended by Tax Tribunal judges, Department of Treasury representatives, Attorney Generals, and state practitioners from across the state. The reception will be held on Thursday, August 23, 2012, at 5 p.m., at Dykema Gossett's Lansing office. Details regarding the event will follow by email.

The SALT Committee cohosted with the SBM Administrative & Regulatory and Public Corporation Sections a Joint Luncheon with Kimbal R. Smith III, Chair of the Michigan Tax Tribunal, on Friday, December 16, 2011, at the Kellogg Hotel & Conference Center in East Lansing. Judge Smith discussed recent developments in law and policy affecting the Michigan Tax Tribunal. The event was well attended by Tax Tribunal members, private practitioners, assessors, and appraisers.

To be added to the SALT Committee email list to receive additional information on upcoming events and activities, as well as state and local tax updates, please contact Jackie Cook.

CHOICE OF ENTITY IN MICHIGAN UNDER THE CORPORATE INCOME TAX

By James F. Anderton, V, Esq. and Michael G. Stefanko, Esq.

One of the fundamental responsibilities of a business or tax attorney is to advise clients about the tax implications involved in choice of entity. As Michigan's new corporate income tax ("CIT") became effective as of January 1, 2012, your authors thought it might be helpful to run through a few scenarios and look at the tax implications for Michigan entities. For those readers familiar with this area, the material which follows is unlikely to yield many surprises. Our goal is to begin the process of familiarizing members of the Bar with the new CIT and to provide materials which may be helpful when explaining to clients the tax ramifications of the various types of entities.

There are three issues which we wish to point out at the start, lest the reader misunderstand our premise for the article. First, this is not an all-inclusive review of the many issues associated with choice of entity. We are not undertaking a review of liability concerns or management concepts. This article is solely about the impact of taxes, including the CIT, on the various types of entities. Second, this article is not a full review of all provisions of the CIT. Regardless of the assumed state of formation, we assume all entities will have all income derived from Michigan sources, so there will be no significant discussions of nexus or apportionment. Nor will we deal with those parts of the CIT addressed to insurance companies and financial institutions. Third, as with all tax articles showing scenarios with different assumptions, there are a myriad of scenarios which may be possible, each of which could have different implications. We have endeavored to make our analysis as generic as possible, in the hopes that it will have the greatest applicability. In the pages that follow, we have tried to explain what assumptions we are making and the tax impact of choice of entity on those assumptions.

The Basic Structure of the CIT

For those looking for the Chapter of the Michigan Complied Laws specific to the CIT, the search will be in vain. Unlike the Single Business Tax and the Michigan Business Tax, the CIT was added to the provisions of the already existing Michigan Income Tax Act.[1] The portions of the CIT addressing the subject of this article are primarily contained in Chapter 10[2], Chapter 11[3], and Chapter 15[4] of the Income Tax Act.

Under the CIT, a taxpayer is subject to the tax if the taxpayer has more than $350,000.00 of gross receipts or if the taxpayer owns or has a beneficial interest in a flow-through entity with substantial nexus in Michigan.[5] The tax is imposed on the "corporate income tax base" at a rate of 6.0%.[6] A corporate income tax base is defined as a taxpayer's "business income" subject to various adjustments which are beyond the scope of this article.[7] Business income is defined as federal taxable income,[8] which is in turn defined to mean taxable income described in Section 63 of the Internal Revenue Code ("IRC") excluding the impact of IRC Sections 168(k) and 199.[9] Two other terms merit definition for purposes of this article. First, "corporation" is defined as an entity that elects to file as a C-corporation under the IRC.[10] Second, a "flow-through entity" is an entity which elects to be taxed as an S-corporation or a partnership (which for state law purposes includes limited liability companies (LLCs)) under the IRC.[11] This allows us a starting place for certain hypothetical scenarios. In all of the scenarios which follow, we assume a for-profit entity with varying amounts of business income.

Under the CIT, once an entity meets the gross receipts and nexus requirements, there is only one credit available to reduce the tax, available to smaller entities.[12] This credit is available to those entities with less than $20,000,000 in gross receipts and that have business income which does not exceed $1,300,000 (adjusted for inflation).[13] The credit is reduced by 20% if compensation and director's fees to any single shareholder or officer exceeds $160,000, with an additional reduction of 20% for each increment of $5,000, until the credit is completely phased out when such compensation and fees to the single highest paid shareholder or officer exceeds $180,000.[14] Note the definition of compensation for this credit is very broad, and includes "all wages, salaries, fees, bonuses, commissions, and other payments" made to an officer, as well as payments subject to or exempt from withholding under IRC Sections 3401-3406.[15] The credit is also phased out for those entities with gross receipts in excess of $19,000,000, with the credit being reduced by 1% for each $10,000 of gross receipts in excess of $19,000,000.[16] For example, an entity with gross receipts totaling $19,620,000, would only be entitled to 38% of the credit.

The credit allowed under the CIT is a credit which reduces the tax imposed by the CIT to the extent it exceeds 1.8% of the entity's business income.[17] Thus, an entity entitled to full use of the credit should never pay more than 1.8% of its business income as calculated under the CIT. To the extent the entity has a shareholder or officer receiving compensation in excess of $160,000, or gross receipts in excess of $19,000,000, the value of the credit will be reduced.

SIMPLIFYING ASSUMPTIONS

In preparing the charts detailing the results of our various scenarios, numerous assumptions were made to help simplify the process. First, we assume that the entity's owner is active in the business, so that either wages from either an S-corporation or C-corporation are appropriate or the distributions from an LLC would be subject to self-employment taxes.[18] Additionally, we ignore the possible impact of loss carry-forwards or carry-backs or any of the multitude of special credits or deductions available in special circumstances. We also assume that all entities described herein have at least $350,000 in gross receipts from Michigan. We have used the 2011 tax charts for all calculations, and at the individual level we have assumed the owner is married, filing jointly and takes only the standard deduction.[19] The charts that follow are designed to give a basic overview of the tax-costs to the owner of the different types of entities at varying income levels.

A brief walk-through of our first chart should explain our process and help to show the impact of the CIT on the choice of entity analysis.

Chart 1

Entity's Income before Owner Wages	$ 250,000.00
C-Corp Wages:	$ 75,000.00
S-Corp Wages:	$ 75,000.00
LLC Payment for Services:	$ 249,580.00
C-Corp Dividend:	$ 113,564.29

	LLC/Partnership	S-Corp	C-Corp	
Entity Level Tax				
Federal Income Tax	-	-	45,147.66	
Employment Taxes				
Social Security (OASDI)	-	4,650.00	4,650.00	*
Medicare (Hospital Insurance)	-	1,087.50	1,087.50	
FUTA/SUTA	420.00	420.00	420.00	**
Michigan Corporate Income Tax	-	-	10,130.55	
Total Entity Level Tax	420.00	6,157.50	61,435.71	
Individual Level Tax				
Federal Income Tax on Ordinary Income	56,460.37	57,922.53	8,400.00	
Federal Income Tax on Dividends	-	-	17,034.64	
Social Security (OASDI)	-	4,650.00	4,650.00	
Medicare (Hospital Insurance)	-	1,087.50	1,087.50	
Self-Employment Tax (Social Security)	13,652.40	-	-	
Self-Employment Tax (Medicare)	6,684.13	-	-	
State Income Tax	10,101.21	10,293.95	7,889.35	
Total Individual Level Taxes	86,898.11	73,953.97	39,061.49	
Total Taxes	87,318.11	80,111.47	100,497.20	
Effective Tax Rate (Both Owner and Entity)	34.93%	32.04%	40.20%	

* Not taking into account the 2% reduction for the first two months in 2012 given that it is likely a one-time exclusion and the 2% is "recaptured" under the act for high income earners and will not be available in future years. Also, for all tables the authors used the 2011 tax tables, but the 2012 taxable wage base.

** Given that the Michigan Unemployment Tax due will vary from year-to-year, we have assumed that the employer will be due the maximum FUTA rate for the owner.

In Chart 1 we see three entities each having $250,000 in income after all expenses except payments to the owner and taxes. In each instance, the owner receives $75,000 in payments for services, and then all available income is distributed to the owner. In the S-corporation and C-corporation situations, the entity will then pay Old Age, Survivors and Disability Insurance (referred to as OASDI or Social Security)[20] and Hospital Insurance (referred to as Medicare)[21] withholding taxes on those wages (equal to one-half of the total amount paid for these taxes), allowing each entity deductions for those expenses. Additionally, all three entities will be responsible for paying the federal or state unemployment tax.[22] After these expenses are considered, the taxable income of each entity can be calculated, and in the case of a C-corporation, the entity's federal income tax can be calculated ($45,147.66 in Chart 1). Additionally, because we can calculate the federal taxable income, that is the C-corporation's business income. The C-corporation's business income is in turn the start of calculating the corporate income tax base upon which CIT is imposed (with an additional tax owing under the CIT of $10,130.55 in Chart 1). For purposes of this article, your authors have assumed that the C-corporation's federal taxable income is equivalent to the entity's business income and corporate income tax base.

After the total taxes paid at the entity level have been calculated, the analysis continues at the owner level. For the owners of the S-corporation and C-Corporation, each will be responsible for payments of the remaining one-half of the OASDI and Hospital Insurance taxes (though these were withheld when payroll was paid). For the member of the LLC, she will be responsible for self-employment taxes against not just the $75,000, but the entire $250,000 allocated to her.[23] The owner of the LLC and the S-corporation will then also owe federal and state income taxes on the income allocated to them from the entity.[24] For the owner of the C-corporation, not only will she have to pay federal and state income tax on her wages, but to receive a distribution of the balance of the funds available to distribute to her in the corporation will require a dividend, which are currently taxed at the capital gains rate ($17,034.64 in Chart 1).[25] Note that because of the payment of federal income tax by the C-corporation, there is significantly less cash available to be distributed to the owner as a dividend as compared to the S-Corporation. For ease of comparison, we have totaled all of the taxes and created a total effective tax rate (total taxes paid divided by the entity's taxable income before owner's wages/payment for services).

Chart 2

Entity's Income before Owner Wages	$ 250,000.00
C-Corp Wages:	$ 239,284.18
S-Corp Wages:	$ 239,284.18
LLC Payment for Services:	$ 249,580.00
Distributions/Dividends to Owner:	$ -

	LLC/Partnership	S-Corp	C-Corp	
Entity Level Tax				
Federal Income Tax	-	-	-	
Employment Taxes				
Social Security (OASDI)	-	6,826.20	6,826.20	*
Medicare (Hospital Insurance)	-	3,469.62	3,469.62	
FUTA/SUTA	420.00	420.00	420.00	**
Michigan Corporate Income Tax	-	-	-	
Total Entity Level Tax	420.00	10,715.82	10,715.82	
Individual Level Tax				
Federal Income Tax on Ordinary Income	56,460.37	56,418.28	56,418.28	
Federal Income Tax on Dividends	-	-	-	
Social Security (OASDI)	-	6,826.20	6,826.20	
Medicare (Hospital Insurance)	-	3,469.62	3,469.62	
Self Employment Tax (Social Security)	13,652.40	-	-	
Self Employment Tax (Medicare)	6,684.13	-	-	
State Income Tax	10,101.21	10,095.66	10,095.66	
Total Individual Level Taxes	86,898.11	76,809.76	76,809.76	
Total Taxes	87,318.11	87,525.58	87,525.58	
Effective Tax Rate (Both Owner and Entity)	34.93%	35.01%	35.01%	

* See note on Chart 1
** See note on Chart 1

ANALYSIS OF THE CIT'S IMPACT

After gaining familiarity with the process to create Chart 1, a review of the material presented should make clear to the practitioner the impact of the CIT on the already tax-disadvantaged C-corporation. Not only does the owner-employee of a C-corporation pay two levels of federal income tax on dividends, she must suffer a state entity level tax that applies only to the C-corporation. In terms of the Effective Tax Rate, this additional tax increases the rate over 4%, from what would have been a 36.15% Effective Rate to a 40.20% Effective Rate. While C-corporations that distribute significant income to their owners via dividends were never tax efficient, the CIT makes them practically a non-option in Michigan.

Another point to be noted in Chart 1 is the advantage of the S-corporation over the LLC. The member of the LLC pays self-employment taxes on all of her distributive share,[26] whereas the S-corporation and its shareholder-employee pay OASDI and Hospital Insurance taxes on only the wages paid (and not on the balance of the distributable profits). This causes a savings to the S-corporation shareholder-employee. The total amounts of OASDI and Hospital Insurance taxes paid in the S-corporation situation are $11,475.00, whereas the LLC's member's self-employment tax payments total $20,336.53. Despite the LLC member being allowed to deduct one-half of this total payment, that tax benefit is not sufficient to make up for the extra dollars paid in the self-employment context on the distributive share.[27]

In Chart 2, we have built off of the Chart 1 scenario, except that now we are assuming that the entity pays out all of the income to the owner as wages or payment for services (for the LLC member). When the full amount available to be paid to the owner is paid in wages, notice the dramatic impact it has on the total effective rate in the C-corporation column. As the amount is paid out in full, there is no taxable income to the C-corporation at the federal level, which also results in there being no corporate income tax base for the CIT to be imposed against. This provides the basis for an important planning opportunity for the CIT – if the C-corporation can legitimately payout all of its profits each year in wages or by another deductible method, the impact of the CIT is effectively neutralized.

Chart 3

Entity's Income before Owner Wages	$ 50,000.00		
C-Corp Wages:	$ 46,056.67		
S-Corp Wages:	$ 46,056.67		
LLC Payment for Services:	$ 49,580.00		
Distributions/Dividends to Owner:	$ -		
	LLC/Partnership	S-Corp	C-Corp
Entity Level Tax			
Federal Income Tax	-	-	-
Employment Taxes			
Social Security (OASDI)	-	2,855.51	2,855.51 *
Medicare (Hospital Insurance)	-	667.82	667.82
FUTA/SUTA	420.00	420.00	420.00 **
Michigan Corproate Income Tax	-	-	-
Total Enetity Level Tax	420.00	3,943.33	3,943.33
Inidivual Level Tax			
Federal Income Tax on Ordinary Income	6,061.59	6,058.50	6,058.50
Federal Income Tax on Dividends	-	-	-
Social Security (OASDI)	-	2,855.51	2,855.51
Medicare (Hospital Insurance)	-	667.82	667.82
Self Employment Tax (Social Security)	5,677.60	-	-
Self Employment Tax (Medicare)	1,327.83	-	-
State Income Tax	1,691.16	1,690.27	1,690.27
Total Individual Level Taxes	14,758.19	11,272.10	11,272.10
Total Taxes	15,178.19	15,215.43	15,215.43
Effective Tax Rate (Both Owner and Entity)	30.36%	30.43%	30.43%

* See note on Chart 1

** See note on Chart 1

Additionally, notice in Chart 2 that when the S-corporation and C-corporation pay out all of the profits as wages, the C-corporation's effective tax rate is identical to the S-corporation's effective tax rate. In this scenario the LLC actually has the lowest effective tax rate because the calculation of self-employment tax includes a slight reduction in the amount subject to those taxes.[28] This concept is can be seen again in Chart 3, showing an analysis of a smaller (or less profitable) entity.

While the analysis of Chart 3 is identical to Chart 2, the lesson for practitioners is that, for the smaller entity, if the entity intends to either stay small, or will be looking for growth via outside sources of money and not retained earnings, the CIT may not cause the C-corporation to be as much of an afterthought as it was in the Chart 1 situation. Also, because the CIT only applies to those entities with at least $350,000 in gross receipts, if an entity will never reach that threshold, its owners do not need to factor in the impact of the CIT on the choice-of-entity analysis. While a small entity is likely to qualify for the credit available under the CIT, the C-corporation would still be responsible for taxes of at least 1.8% of its business income, causing it to be in a disadvantaged position compared to an LLC or S-corporation. The analysis related to payroll taxes remains the same as above.

An example working through the value of the small business credit to the CIT is found in Chart 4. In this scenario, each entity has $250,000 in profit excluding the owner's payments, and it makes payments to the owner of only $75,000 (with no other distributions or dividends). As the entity did not exceed $160,000 in payments to its owner/officer, and we assume it had less than $19,000,000 in gross sales, it qualifies in full for the credit.

This leads to the interesting result that, due to the credit, the C-corporation ends up with the lowest Effective Tax Rate. Due to the graduated corporate income tax rates and the credit, the money retained in the C-corporation is in a more advantageous entity than the money in an S-corporation or an LLC. However, if the C-corporation cannot ultimately distribute that money in a deductible manner (either as wages to the owner or otherwise to grow the business), and the owner takes the distribution via a dividend, the net result will not be efficient from a tax perspective.

Chart 5 describes a larger (or more profitable) entity looking for further growth. We assume that, as the entity grows, its owner increases her compensation. In this instance, we assume $1,000,000 in taxable income before payments to

Chart 4

Entity's Income before Owner Wages	$ 250,000.00			
C-Corp Wages:	$ 75,000.00			
S-Corp Wages:	$ 75,000.00			
LLC Payment for Services:	$ 249,580.00			
Distributions/Dividends to Owner:	$ -			
	LLC/Partnership	S-Corp	C-Corp	
Entity Level Tax				
Federal Income Tax	-	-	47,913.30	
Employment Taxes				
Social Security (OASDI)	-	4,650.00	4,650.00	*
Medicare (Hospital Insurance)	-	1,087.50	1,087.50	
FUTA/SUTA	420.00	420.00	420.00	**
Michigan Corporate Income Tax	-	-	3,039.17	
Total Entity Level Tax	420.00	6,157.50	57,109.97	
Individual Level Tax				
Federal Income Tax on Ordinary Income	56,460.37	57,922.53	8,400.00	
Federal Income Tax on Dividends	-	-	-	
Social Security (OASDI)	-	4,650.00	4,650.00	
Medicare (Hospital Insurance)	-	1,087.50	1,087.50	
Self Employment Tax (Social Security)	13,652.40	-	-	
Self Employment Tax (Medicare)	6,684.13	-	-	
State Income Tax	10,101.21	10,293.95	2,949.30	
Total Individual Level Taxes	86,898.11	73,953.97	17,086.80	
Total Taxes	87,318.11	80,111.47	74,196.77	
Effective Tax Rate (Both Owner and Entity)	34.93%	32.04%	29.68%	

* See note on Chart 1

** See note on Chart 1

Chart 5

Entity's Income before Owner Wages	$ 1,000,000.00			
C-Corp Wages:	$ 200,000.00			
S-Corp Wages:	$ 200,000.00			
LLC Payment for Services:	$ 999,580.00			
Distributions/Dividends to Owner:	$ -			
	LLC/Partnership	S-Corp	C-Corp	
Entity Level Tax				
Federal Income Tax	-	-	252,437.27	
Employment Taxes				
Social Security (OASDI)	-	6,826.20	6,826.20	*
Medicare (Hospital Insurance)	-	2,900.00	2,900.00	
FUTA/SUTA	420.00	420.00	420.00	**
Michigan Corporate Income Tax	-	-	47,391.23	
Total Entity Level Tax	420.00	10,146.20	309,974.70	
Individual Level Tax				
Federal Income Tax on Ordinary Income	312,650.54	316,320.33	44,069.50	
Federal Income Tax on Dividends	-	-	-	
Social Security (OASDI)	-	6,826.20	6,826.20	
Medicare (Hospital Insurance)	-	2,900.00	2,900.00	
Self Employment Tax (Social Security)	13,652.40	-	-	
Self Employment Tax (Medicare)	26,770.25	-	-	
State Income Tax	42,289.34	42,745.44	8,386.80	
Total Individual Level Taxes	395,362.53	368,791.97	62,182.50	
Total Taxes	395,782.53	378,938.17	372,157.20	
Effective Tax Rate (Both Owner and Entity)	39.58%	37.89%	37.22%	

* See note on Chart 1

** See note on Chart 1

the owner and $200,000 in payments to the owner. As this amount is more than the $180,000 upper-end limit of compensation in the CIT credit, the credit is not available. If the entity looks at retained earnings as a method to finance growth, the CIT could come into play with a vengeance. While the preferred method to finance growth cannot always be known at the time of formation of the entity, in some circumstances this issue is part of the conversation which should be had with the entrepreneur.

As was mentioned immediately above, Chart 5 outlines a situation where a larger entity desires to finance future growth through retained earnings.[29] In this instance the impact of the CIT is significant ($47,391.23 in this scenario). This is a clear example of those entities subject to the CIT who cannot avail themselves of the credit nor find deductible methods to reduce their business income will be subject to a significant tax burden. However, if the goal is only to finance future growth of the entity, the C-corporation may still have value in the choice of entity decision process, because there is not flow-through taxation of the additional money retained within the entity to the owner. This point is made clear because in Chart 5 the C-corporation actually has the lowest effective tax rate, which is due to individual owner being liable only for those taxes associated with the $200,000 in wages paid to her, while the LLC member and S-corporation shareholder each had significant income tax liabilities due to the flow-through nature of those entities.[30]

Conclusion

The new CIT is unlikely to cause most practitioners significant challenges when discussing choice of entity with entrepreneurs. Overall, most state income taxes are ancillary issues to the larger federal taxes. In the case of the CIT, it merely amplifies the tax benefits and costs of various entity structures inherent in the federal system. In the future, there may be planning strategies other than those addressed herein to minimize the CIT, but as the tax in many instances can be entirely avoided by an election, practitioners are well advised to be wary about recommending a C-corporation to a Michigan entrepreneur.

About the Authors

James F. Anderton, V is a shareholder of Loomis, Ewert, Parsley, Davis & Gotting, P.C. in Lansing, Michigan, and has written previously for the Michigan Tax Lawyer. *Michael G. Stefanko is an associate attorney with Loomis, Ewert, Parsley, Davis & Gotting, P.C. in Lansing, Michigan, and is also a Certified Public Accountant licensed in Michigan.*

Endnotes

1 MCL 206.1 *et. seq.*

2 MCL 206.601 *et. seq.*

3 MCL 206.621 *et. seq.*

4 MCL 206.671 *et. seq.*

5 MCL 206.621(1).

6 MCL 206.623(1).

7 MCL 206.623(2).

8 MCL 206.603(2).

9 MCL 206.607(1).

10 MCL 206.605(1).

11 MCL 206.607(2).

12 Note that certain other credits may carry over for existing entities, but for an entrepreneur facing the choice of entity question for a new entity, those credits would not be applicable.

13 MCL 206.671(1). It is worth noting that in defining the credit, business income starts with federal taxable income, but then adds back in compensation and directors' fees of active shareholders. MCL 206.671(10)(b).

14 MCL 206.671(1)(b)(*i*)-(*iv*).

15 MCL 206.671(10)(d). Though not explicit in the statute, the reference to IRC §3406 appears to make dividend payments includible in the definition of compensation.

16 MCL 206.671(5).

17 MCL 206.671(4).

18 See Internal Revenue Code ("IRC") § 1402 for definitions regarding what is subject to the self-employment income tax.

19 Your authors realize that the standard deduction is very unlikely, if for no other reason than the various deductions available on the Charts. However, in an effort to standardize the scenarios, we have kept the standard deduction.

20 IRC §3101(a), and is limited by the taxable wage base per IRC §3121(a)(1).

21 IRC §3101(b), and is not limited by the taxable wage base.

22 IRC §3301, and note the credit for payments to approved state unemployment funds under IRC §3302.

23 IRC §164(f) one-half of the self-employment amount is deductible to the member, as the S-corporation and C-corporation get to deduct one-half of the Social Security and Medicare taxes they pay on behalf of the employee.

24 See §61(a)(13) for an LLC member and §1366(c) for the S-corporation shareholder.

25 We assume all dividends qualify as "qualified dividends" under IRC §1(h)(11). We have assumed a 15% tax-rate.

26 The LLC member will only pay that portion of self-employment taxes for social security up to the taxable wage base (IRC §1402(b)(1)), but will pay Hospital Insurance taxes on the entire allocated amount.

27 The authors assume that the wages paid to the S-corporation's shareholder-employee are reasonable under the circumstances. A review of the risks and justifications of this technique are outside the scope of this article.

28 See Schedule SE (Form 1040) 2011, Part I, Line 4a.

29 The authors wish to thank Michael S. Flintoff, CPA, J.D., LL.M., for pointing out that there are other reasons a corporation may want to retain cash, including to fund the redemption of an owner.

30 The authors note that because of the assumption of the individual taking only the standard deduction, this circumstance is very unlikely. In each instance the individual is leaving over $30,000 in deductions unclaimed, which would certainly alter the total effective tax rate, and make both entities more competitive with the C-corporation situation.

GET AUDIT-READY IN MICHIGAN BY GETTING READY FOR STATISTICAL AND NON-STATISTICAL SAMPLING

By Carolee Kvoriak Cameron, Esq.

In a business world that generates records by the reams, it is not uncommon for taxing authorities to resort to sampling procedures to efficiently complete an audit. It is also not uncommon for taxpayers themselves to use the same procedures when filing refund claims or defending against an audit, although whether a sample will be accepted when proposed by the taxpayer is not always a given.[1] The Michigan Department of Treasury ("Treasury") uses sampling procedures in two areas in particular: 1) unclaimed property and 2) sales and use tax. Treasury is allowed to use "reasonable estimations" in unclaimed property audits under limited circumstances.[2] Another is sales and use tax, where the Michigan Department of Treasury has issued a recent internal policy directive advising taxpayers on the use of sampling procedures.[3]

When records are particularly voluminous, a carefully constructed sampling procedure, correctly applied, may make the audit less burdensome for both Treasury and the taxpayer. This article describes some common issues a taxpayer may want to consider if asked to consider a sampling procedure in connection with a Treasury audit. [4]

Examine the state of the books and records to see if sampling is appropriate.

Preferably this should happen before the auditor even arrives. When the taxpayer's books and records are adequate but merely voluminous, sampling might be considered and explored for the convenience of both the auditor and the taxpayer. The taxpayer could always resort to the actual records in the event something about the sampling looks fishy. But if records are inadequate, not only will the taxpayer not have a choice as to whether sampling will be used, it may have an uphill battle trying to prove any discrepancies.

Generally, the burden is on the taxpayer to prove that its books and records are adequate.[5] Taxpayers should be careful, however, in allowing the auditor to automatically find records to be inadequate – the auditors may do so simply to short cut the audit or in order to use a method more likely to result in a higher assessment.[6] The Michigan Unclaimed Property Act, for instance, requires certain records to be kept as specified in Mich. Comp. Laws Ann. §567.252.[7] Only the failure to do so allows the auditor to assess an amount "as may reasonably be estimated from any available records."[8] The IRS cautions against using sampling if the taxpayer can "reasonably obtain more accurate information."[9]

The Michigan Tax Tribunal (the "Tribunal") recently cancelled a sales tax assessment because it determined that the auditor was too quick to use sampling when actual records were available. In *SMK LLC v. Department of Treasury,*[10] rather than examine the daily cash register tapes made available by the taxpayer, the auditor estimated a sales tax liability by projecting amounts from a two-month sample of purchase invoices extrapolated over a four-year period. This, the taxpayer argued, failed to take into consideration inventory shrinkage from spoilage, damage, employee theft and other loss events. Treasury argued that the projection was appropriate because there was no way to ensure that the taxpayer's employees properly rang up the daily cash register tapes thus calling into question the integrity of the taxpayer's books and records. The Tribunal disagreed with this conclusion, found that the taxpayer maintained adequate controls over its employees and cancelled the assessment.

A number of other recent Michigan Tax Tribunal cases address the same issue of proper sampling techniques in the context of sales and use tax audits of grocery stores.[11] These cases often turn on the adequacy of the petitioner's records. When the petitioner's records are found records are found to be to be adequate, the Michigan Department of Treasury's sampling technique is rejected. But when the petitioner's records are inadequate, the Michigan Tax Tribunal most often finds that the Michigan Department of Treasury is entitled to base its assessment on the best information available. Along the same vein, is a recent federal case *Bayer Corp. v United States.*[12] The taxpayer in that case did not produce the large volume documents requested by the Internal Revenue Service but instead proposed a sample. The US District Court for the District of Western Pennsylvania refused to allow this request, on the grounds that it would reward Bayer for failing to keep adequate records (although query whether Bayer failed to keep adequate records but merely protested having to produce the billions and billions of pages of documents it claimed the government requested).

Understand the different types of sampling that may be used.

This is another step that should be preferably taken before the auditors come knocking. Internal Policy Directive 2009-2 describes a number of methods that may be used by Treasury to construct a sample.[13]

The most reliable method of sampling is statistical sampling – generally defined as any approach that involves the random selection of a sample and the use of probability theory to evaluate the sample.[14] The sample is usually randomly generated by means of computer software. The entire population of records available is first stratified into dollar values with a low dollar value range and a high dollar value range, as agreed to by both the taxpayer and Treasury. Between these two ranges a number of other ranges may be constructed, depending on the size of the initial population. These ranges may be further stratified by other characteristics, such as location, types of accounts – the goal is to break the population into small groups that are likely to share a common error rate. These groups must have enough items in the stratification in order to be statistically valid but yet not be so large as to create unnecessary work. The internal policy directive requires a minimum of 30 sample items for each stratified range except the high dollar range, which may have no minimum number of items.

Statistical samples also include a measurement of sampling risks, usually expressed in terms of two percentages. The first of these two percentages is generally referred to as the "confidence" level. Internal Policy Directive 2009-2 requires a confidence level of 90%, which refers to how likely is that the items sampled will fall within the second percentage, the precision level. The precision level is the likelihood that a particular item sampled will be accurate, meaning that it will be within a certain percent above or below the actual result. Internal Policy Directive 2009-2 requires a precision level of 10%. In other words, for a statistical sample to be valid under Internal Policy Directive 2009-2, 90% of the samples drawn must be within 10% of the actual result.

To illustrate, an auditor might construct a population of records for one particular period and use it either to estimate a liability for that period rather than examine each and every record. The auditor would input the entire population into the computer software used to generate the sample by stratifying the population into dollar ranges such that the required confidence and precision levels are met. The auditor would then audit the sample items only rather than audit the entire population and would construct an error rate based on the sample items audited. This error rate would be applied against the entire population being audited. The actual mechanics of this part of the sampling procedure are not controversial as they are based on generally accepted sampling practices. What tends to be more controversial is whether sampling should be employed in the first place and then whether the samples were drawn from a valid population.

A non-statistical method refers to any method for which the sample is not generated randomly from an entire population. One example of this is when the auditor uses block sampling – a review of all the transactions for a particular time period where the result of this review is then extrapolated over the entire length of the audit. The auditor in *SMK, LLC*, for instance, used block sampling when he choose two months of purchase invoices from a four-year period and then used the results to extrapolate an assessment for the entire four years. If an auditor proposes to use some sort of non-statistical sampling, the taxpayer should consider whether the method proposed fairly represents normal business conditions throughout the audit period. For instance, for a seasonal business or business that is fairly new, not all months are likely to be the same. Earlier months may have had less volume, winter months may be slower than summer months, or a particular month may have had some extraordinary circumstance that makes it not particularly representative of the audit period as a whole.

Sometimes auditors may use external factors common to a particular industry in order to extrapolate an audit result. For instance, in *SMK, LLC*, rather than rely on the taxpayer's actual sales (as evidenced by the daily cash register tapes), the auditor took the taxpayer's purchase invoices and applied a "standard" profit percentage. Obviously the selection of that profit percentage can be subjective and who's to say that the "standard" is actually representative of any a particular taxpayer. Another example is a method not commonly seen in Michigan but recently used in New Jersey by a third-party auditor, Chainbridge LLC. The State of New Jersey contracted with Chainbridge to select audit targets for state transfer pricing audits. Chainbridge would do so by feeding publicly available information, such as financial statements, into its internally-developed computer software and determine whether a potential audit target's profits were consistent with its industry peers. The State of New Jersey was in effect conducting at least the initial stage of its audits without examining a single actual taxpayer record. Political pressure from taxpayers recently convinced New Jersey officials to end this particular practice.

Regardless of whether the auditor plans on using a statistical or non-statistical sample method, consider whether the population selected is a fair representation of the results to be ultimately reached

The taxpayer should make sure it is appropriate to include all transactions and all entities in the scope of the population to be sampled. This is probably one of the most difficult aspects of analyzing the proper use of sampling procedures. A particular population, for instance, may have bookkeeping entries that are meant to correct or reclassify prior entries and do not represent actual transactions or it may contain duplicate entries or voided transactions. These transactions should be excluded from the sample. Certain types of entities might be excluded as well – for instance in an unclaimed property audit, transactions for entities that do not hold property belonging to others in the ordinary course of its business should not be included in the population making up the sample.

Also consider whether all items in the population properly represent the issue being audited. For instance, in an unclaimed property audit for a single state, the auditor should only be examining a population consisting of items properly escheated to that state and not to other states.

Once a valid sample has been constructed and an error rate has been determined, make sure the error rate is being applied against the correct base

The auditor will actually audit the sample items drawn from the entire population and then use those items to construct an error rate. For instance, assume a particular population consists of 1,000 items with a dollar value of $1,000,000. A sample of 100 items with a total dollar value of $10,000 are randomly selected and actually audited. From these 100 items, the auditor determines that ten items were not properly taxed and that the tax liability for these ten items is $150. The error rate for this sample is $150 (the actual tax liability) divided by $10,000 (the total dollar value of the items randomly selected), or 1.5%.

The next question is against what base should the 1.5% error rate be applied. If the purpose of the sample was to apply the error rate only against the items making up the initial population, and assuming the population is made up only of items that are validly included in the scope of the audit, then the answer is pretty straightforward – the auditor would apply the error rate against the dollar value of the population so that the result of the audit would be a tax liability of $15,000. The answer requires a little more analysis if the auditor wants to apply the error rate to a population, or base, from which the error rate was not drawn. Is it proper, for instance, to use the error rate above against the taxpayer's entire revenues in an earlier year, as opposed to some other category of income or expense? The population from which the error rate was drawn should closely match the population against which it is applied.

The steps described above should be considered as early in the audit process as possible

Addressing the issue at the beginning of the audit will allow the taxpayer more time to appreciate the state of its books and records, fully understand the exact methods to be used, consider whether there are any flaws in those methods and consider whether the population of items to be sampled adequately represents the objectives of the audit and the transactions within the scope of the audit. Ask the auditor as soon as possible, to define the method being used and to what transactions and entities the method will apply.

About the Author

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Endnotes

1 *See, e.g., Bayer Corp. v. United States,* Civ. Action No. 09-351 (W.D. Pa. Feb. 6, 2012), in which the US District Court for the Western District of Pennsylvania refused to require the Internal Revenue Service to accept a sample for the taxpayer's research and development credit under Internal Revenue Code Section 41. It should be noted, however, in light of the fact that the taxpayer and the Internal Revenue Service originally settled the years in question when the taxpayer filed a refund claim for additional credit based on a methodology prepared by a national accounting firm. Such refund claims have not been particularly well-received by the Internal Revenue Service in recent years, which may have been part of the reason why the government refused to consider a sample for the claim.

2 Mich. Comp. Laws Ann. § 567.251(5).

3 Michigan Department of Treasury Internal Policy Directive 2009-2, *Sales and Use Tax – Audit Sampling Procedures* (June 22, 2009). Although internal policy directives do not have the force of law and are therefore not binding on taxpayers, they do provide guidance to Treasury personnel on specific issues and are helpful in determining how the Department of Treasury may treat a particular issue.

4 Sampling procedures are widely used by not only Treasury but the Internal Revenue Service (the "IRS") and other state taxing authorities. The IRS recently issued Revenue Procedure 2011-42, 2011-37 IRB 318 (Aug. 18, 2011), providing guidance on the use and evaluation of statistical sampling to support items on a tax-

payer's income tax return. Revenue Procedure 2011-42 modifies and amplifies other IRS guidance addressing sampling, including: Revenue Procedure 2011-35, 2011-25 IRB 890 (safe harbor methods to determine basis in stock acquired in transfer basis transactions); Revenue Procedure 2004-29, 2004-1 CB 918 (sampling methodology to establish meal and entertainment expenses excepted from the 50% deduction disallowance); Revenue Procedure 2007-35, 2007-1 CB 1349 (sampling for purposes of Section 199 of the Internal Revenue Code). The American Institute of Certified Public Accountants and the Multistate Tax Commission have also proposed standards for sampling.

5 See, for instance, *Vomvolakis v. Department of Treasury,* 145 Mich. App. 238; 377 NW2d 309 (1984); *Summerville v. Department of Treasury*, MTT Docket No. 149724 (1994) ("taxpayer must show that the assessments are improper, unlawful or inappropriate").

6 This is particularly troublesome when used by third-party contingency fee auditors with a financial interest in the outcome of the audit.

7 Mich. Comp. Laws Ann. § 567.252 requires a holder to maintain a record of the name and last known address of the owner of any unclaimed property for ten years after the property becomes reportable. It also requires sellers of travelers checks, money orders or other similar written instruments to maintain a record of those instruments while they remain outstanding and indicate a state and date of issue for three years after the date the property becomes reportable as unclaimed property.

8 Mich. Comp. Laws Ann. § 567.251(5).

9 See e.g., IRS Memorandum for Industry Directors, *Field Directive on the Use of Estimates from Probability Samples* (November 3, 2009).

10 Michigan Tax Tribunal Dkt. No. 409504 (Sept. 26, 2011).

11 *See, e.g., Fradco, Inc. v Michigan Department of Treasury*, MTT Docket No. 409506 (Sept. 26, 2011); *Plum Hollow Market, Inc. v. Michigan Department of Treasury*, MTT Docket No. 348020 (May 16, 2011); *BIP, Inc. d/b/a Village Party Store v. Michigan Department of Treasury*, MTT Docket No. 322999 (April 13, 2010).

12 Supra at note 1

13 Although Internal Policy Directive 2009-2 is specific to the sales and use tax, the methods described are ones of general application. The author is currently handling an unclaimed property audit where the auditors are using the sampling procedures described in Internal Policy Directive 2009-2.

14 See, for instance, the Multistate Tax Commission Model Regulation.

THE IRS's VOLUNTARY CLASSIFICATION SETTLEMENT PROGRAM MAY HELP MICHIGAN BUSINESSES

By William C. Lentine, Esq. and Gabriel Marinaro, Esq.

A debate over whether to classify workers as independent contractors or employees has been raging for decades among the Internal Revenue Service (the "IRS"), tax practitioners and many Michigan businesses. In many instances, it is advantageous for a business to hire workers as independent contractors, since this allows the business to generally avoid the payroll taxes and employment law compliance issues that accompany the hiring of an employee. What many businesses in Michigan do not realize, however, is that the IRS, the U.S. Department of Labor ("DOL") and certain Michigan governmental agencies can, and regularly do, look beyond any written contracts between workers and businesses, seeking to discover whether a Michigan business has misclassified some or all of its workforce as independent contractors instead of as employees. Regardless of any ambiguities in a worker's classification, recipients of IRS letters assessing a fortune in federal employment taxes, penalties and interest generally do not receive the benefit of doubt for allegedly improperly treating employees as independent contractors. The worst aspect for owners, officers and other business executives is that they may face the daunting reality that they are personally liable for the unpaid employment taxes pursuant to the trust fund recovery penalties under Internal Revenue Code Section 6672(a).

In connection with IRS's efforts to collect federal employment taxes in a situation where workers have been misclassified as independent contractors, the IRS recently announced its Voluntary Classification Settlement Program ("VCSP") to permit businesses to "voluntarily reclassify workers as employees for federal employment tax purposes."[1] The purpose of this Article is to highlight the provisions of the VCSP that are detailed in IRS Announcement 2011-64.

Although not the primary topic of this Article, it is important to note that, a few days prior to the IRS's announcement of the VCSP, the IRS and DOL entered into a Memorandum of Understanding ("MOU") with respect to a joint initiative for the purpose of information sharing and collaboration on efforts to "reduce the incidence of misclassification of employees as independent contractors, help reduce the tax gap, and improve compliance with federal labor laws."[2] In connection with this joint initiative, the DOL will, among other things, refer to the IRS (at the DOL's discretion and consistent with applicable law), Wage and Hour Division investigation information and other data that DOL believes may raise federal employment tax compliance issues related to worker misclassification. Pursuant to the MOU, the IRS will, among other things, evaluate the referrals provided by the DOL to determine whether to conduct an examination to determine federal employment tax compliance. Another responsibility of the IRS in connection with the MOU is the sharing of the DOL referrals with state and municipal taxing agencies that are authorized to receive tax return information under agreements with the IRS. The IRS will, at its discretion and pursuant to applicable laws, provide the DOL with information (other than taxpayer return information) which may constitute evidence of a violation of any Federal criminal law (not involving tax administration) that is enforced by the DOL. Although not directly linked with the VCSP, this MOU is evidence of increased cross-agency collaboration on worker misclassification issues.

Voluntary Classification Settlement Program – IRS Announcement 2011-64

Historically, the IRS has been active in its effort to bring taxpayers into conformity by offering varying degrees of clemency for past violations and now the IRS is continuing its effort with the new VCSP.[3] In Announcement 2011-64, the IRS provides that the VCSP is "optional and provides taxpayers with an opportunity to voluntarily reclassify their workers as employees for future tax periods with limited federal employment tax liability for the past nonemployee treatment." Announcement 2011-64 provides further that, "[i]n order to facilitate voluntary resolution of worker classification issues and achieve the resulting benefits of increased tax compliance and certainty for taxpayers, workers and the government, the IRS has determined that it would be beneficial to provide taxpayers with a program that allows for voluntary reclassification of workers as employees outside of the examination context and without the need to go through normal administrative correction produces applicable to employment taxes." Essentially, significant leeway will be granted to qualifying businesses that agree to prospectively classify as employees those workers who are being incorrectly treated as independent contractors. In January 2012, an IRS official stated in a phone conference with payroll industry representatives that the IRS has received 217 VCSP applications.[4]

In order to be considered for participation in the VCSP, an eligible taxpayer (see below regarding eligibility requirements) must apply first using the Form 8952 – "Application for Voluntary Classification Settlement Program.[5] According to the IRS FAQs on the VCSP (see note 8), the Form 8952 should be filed at least 60 days from the date the taxpayer wants to begin treating the workers as employees. After the eligible taxpayer submits the Form 8952, the IRS will review the application and verify eligibility. Once the IRS accepts the taxpayer into VCSP, the IRS will contact the taxpayer to enter into the VCSP closing agreement with the IRS.

According to 2011-64, employers accepted into the VCSP will be required prospectively treat the class of workers as employees for future tax periods. In exchange for this prospective treatment, the IRS permits taxpayers under the VCSP to (i) pay 10% of the employment tax liability that may have been due on compensation paid to the class of workers subject to the VCSP submission for the most recent tax year, calculated under the reduced rates of Code Section 3509(a); (ii) the taxpayer will not be liable for any interest and penalties on the employment tax liability with respect to the class of workers subject to the VCSP submission; and (iii) will not be subject to an employment tax audit with respect to the classification of workers subject to the VCSP submission for prior years. Additionally, 2011-64 requires that the taxpayer agree to extend the period of limitations on assessment of employment taxes for three years for the first, second and third calendar years beginning after the date on which the taxpayer has agreed under the VCSP closing agreement to begin treating the workers as employees.

To be eligible for relief under the VCSP, employers must:

- Not be currently involved in an IRS audit;[6]
- Not be currently involved in an audit by any state agency or the DOL regarding the classification of the related workers;
- Have consistently treated the applicable workers in the past as non-employees; and
- Have properly filed all Form 1099's, when required, for the workers during the previous three years.

To assist employers in determining entrance into the VCSP and to outline issues which arise in the VCSP, the IRS issued 23 frequently asked questions ("FAQs").[7] Several FAQs clarify the new VCSP as follows:

- IRS's rejection of a VCSP application will not automatically trigger initiation of a Federal audit. The rejected taxpayer could be audited for another reason, but not as a result of filing the Form 8952. (FAQ 21)
- The VCSP concerns future years only. Thus, IRS won't make any determination with regard to prior years and a taxpayer that signs a VCSP isn't making any representation as to the workers' proper status for prior years for federal employment tax purposes. In other words, a taxpayer that signs a VCSP closing agreement is not admitting liability or wrongdoing for past periods. (FAQ 22)
- A taxpayer can't participate in the VCSP if its parent or subsidiary or another member of its consolidated group is under IRS audit. (FAQ 23)
- One of the threshold qualifications for the VCSP is filing Forms 1099 for the previous three years for affected workers. The IRS indicated that a taxpayer will be eligible for the VCSP if it files the required Forms 1099 within 6 months of their due date (including extensions), assuming the other eligibility requirements are met. Those that haven't previously filed required Forms 1099 or filed them more than 6 months after their due date (including extensions) are not eligible for the VCSP. (FAQ 20)

The IRS also clarifies that a worker's filing of Form SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding) isn't treated as an audit and won't bar the taxpayer from participating in the VCSP.

In order for a taxpayer to understand whether they should submit a VCSP filing, the taxpayer must understand whether the applicable worker is properly classified as an employee as opposed to an independent contractor. Determining a worker's status as an "employee" may vary depending on which federal statute is being applied (e.g. Employee Retirement Income Security Act, Americans with Disabilities Act, Age Discrimination in Employment Act, etc.) but the IRS formerly acknowledged a list of twenty "common law" factors to address proper classification of a worker.[8] On audit, examining agents are directed to look at three categories of evidence: behavioral control, financial control, and relationship of the parties.[9] Frequently, cases are leaning toward reliance on groups of factors significant to an industry so understanding the general practice in a taxpayer's particular industry is significant.

In order to appreciate the significant benefit of the VCSP, consider an example of reclassification of several workers from independent contractor to employee under the VCSP. Assume that the employer has three workers whom each earn $40,000 per year and were improperly characterized as independent contractors. The workers should be categorized as employees because of the control exerted by the employer (employer has set hours, directs how the work is to be completed, provides all the equipment, etc.).

The VCSP payment is calculated based on compensation paid to the workers subject to the VCSP submission in the most recently completed tax year, determined at the time the VCSP application is being filed. For our example below, assume the VCSP application is filed in 2012 so the workers' 2011 year compensation would be use

$40,000 per Form 1099	Applicable Rates for 2011[10]	VCSP Assessment
FICA-Employer's	6.20%	$2,480
FICA-Employee's	.84%	$336
Medicare-Employer	1.45%	$580
Medicare-Employee	.29	$116
Federal Inc. Withholding	1.50%	$600
Total	10.28%	$4,112

Therefore, the total assessment for the three workers in the example above would be $12,336 using the 2011 effective rate of 10.28% under Code Section 3509(a). However, the VCSP merely uses 10% of this $12,336 as the liability under the program. Thus, the employer would pay $1,234 under the VCSP for these three workers. This is exclusive of any state and local assessments which may apply.

While the savings above are impressive, the VCSP is not a magic bullet. Taxpayer's should heed a warning that, with a reclassification of some or all of its workers, it could be opening up many other issues, including, but not limited to, state classification issues and issues under other federal laws (e.g. potential retroactive participation in employee benefit plans and participant rights under ERISA; rights under the Fair Labor Standards Act, Age Discrimination in Employment Act, Americans with Disabilities Act, Title VII of the Civil Rights Act, etc.). While certain FAQs say the IRS won't share information about VCSP participants with the DOL or state agencies,[11] the potential exists that, when a taxpayer changes the classification of certain workers to employees, its various governmental agency filings following the change in classification may appear inconsistent in a governmental agency's records and could raise flags for an audit. Since the Michigan Department of Treasury may enforce the strict letter of the law for past violations without consideration of the voluntary nature of disclosures, employers should consider actions carefully before reclassifying a worker as an employee for one governmental agency and not treating as an employee for another governmental agency.

CONCLUSION AND RECOMMENDATIONS

Businesses interested in the VCSP should speak with their tax or employee benefits attorney to explore the benefits of the VCSP and the potential implications of re-classifying independent contractors as employees. With federal and state governments on the prowl for funding sources this issue is not going away. If a business has been burying its head in the sand and ignoring this issue, now may be the time to bring the employment practices into compliance. Since there are differences between agencies as to what constitutes an employee and what constitutes an independent contractor, advisors with competency in both areas should be consulted before enacting changes in classifications.

ABOUT THE AUTHORS

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ENDNOTES

1 IRS Announcement 2011-64, 2011-41 IRB.

2 Memorandum of Understanding between the IRS and DOL, dated September 19, 2011. The specific objectives of the MOU include the following: "expand the IRS-DOL partnership launched in the Questionable Employment Tax Practices Program; reduce the employment tax portion of the tax gap; increase compliance with federal employment and unemployment tax requirements; increase compliance with federal labor laws enforced by the DOL; reduce fraudulent filings; reduce abusive employment/unemployment tax schemes; reduce worker misclassification; reduce questionable employment tax practices; work together to create educational and outreach materials and guidance for employers and workers."

3 In 1996, the IRS implemented the Classification Settlement Program which was designed to allow taxpayers and examining agents to resolve worker classification issues as early as possible in the administrative process. The CSP was initially enacted for a two-year trial period but then indefinitely extended in Notice 98-21, 1998-1 C.B. 849. In 2009, the IRS began a National Research Project and Audit Initiative which identified the IRS's plans to audit six thousand employers in a three year period. In 2012, the IRS will audit two thousand employers under this program. The National Research Project and Audit Initiative and the VCSP are

examples of the IRS's increased attention in the employment classification area.

4 Pension & Benefits Reporter, Vol. 39, No.2 (January 10, 2012), page 53, Bloomberg BNA.

5 The Form 8952 and instructions on the Form 8952 can be found at the following link: http://www.irs.gov/formspubs/article/0,,id=242970,00.html. No payment should be submitted with the Form 8952.

6 A taxpayer who was previously audited by the IRS or the DOL concerning the classification of the workers will only be eligible if the taxpayer has complied with the results of that audit.

7 Available at: http://www.irs.gov/businesses/small/article/0,,id=246014,00.html.

8 The IRS had acknowledged that the 20 "common law" factors listed in Rev. Rul. 87-41 but also indicated that those "are not the only ones that may be important." The IRS's Training Course on classifying workers emphasizes that the standard and main test is "control." Equally significant is the U.S. Supreme Court's decree in *Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440 (2003) in which the Court decreed that the focus should be on "the common law touchstone of control".

9 IRM 4.23.5.6.1(2) (11-03-2009); IRM Ex. 4.23.5-1, Determining the Right to Direct or Control (2-1-2003); IRS Training Course, at pp. 2-1 through 2-6.

10 Under Code Section 3509(a), the 10.28% (for compensation paid in 2011 up to the Social Security Wage base) effective tax rate applies under the VCSP in 2012. For compensation above the Social Security wage base, the rate of 3.24% is used.

11 Specifically, FAQs 18 and 19, available at: http://www.irs.gov/businesses/small/article/0,,id=246014,00.html