2009
MICHIGAN UNEMPLOYMENT INSURANCE UPDATE

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- UIA Audits, Appeals & Settlements
- Federal SUTA Dumping Prevention Act
- SUTA Dumping & Successor Liability
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By: Alan M. Valade, Partner

Honigman Miller Schwartz and Cohn LLP
660 Woodward Avenue
2290 First National Building
Detroit, MI 48226-3506
Telephone: 313-465-7636
E-Mail: avalade@honigman.com

I. INTRODUCTION.

Michigan utilizes a gross wage record system, reported quarterly by employers, to determine entitlement to unemployment benefits for unemployed workers and employment taxes and contributions by employers. The Michigan Unemployment Insurance Agency ("***UIA***") administers the payment of unemployment benefits and the collection of unemployment taxes and contributions from employers under the Michigan Employment Security Act (the "***MES Act***"). See, MCL 421.1, et seq.

A. A Liable Employer.

Generally, a liable employer is an "employing unit" that either (1) employed 1 or more employees in each of any 20 different weeks in a calendar year; or (2) paid $1,000 or more in payroll in a calendar year to employees covered by the MES Act; or (3) acquired the trade, organization, or business, or a portion of the assets of a liable employer.

B. The 2009 UI Payroll Tax Base.

The 2009 Michigan unemployment insurance ("***UI***") tax base is the first $9,000.00 of covered compensation paid to each employee each year. The federal minimum UI tax base is $7,000.00 established in 1983. Other States' taxable wage bases range from $7,000 (the federal minimum) to $34,000 (Washington).

The UI payroll tax is a "per worker" tax. If a worker holds a given job all year, the employer pays the UI tax once. If two workers hold the job (one quits in June of 2009 and a new employee is hired in July of 2009), the employer pays the tax twice (once for each worker).

Wage detail information must be provided for every covered employee to whom wages were paid during the calendar quarter.

C. UI "Experienced" Tax Rates.

Except for new employers, UI payroll tax rates are experience rated. This generally means that an employer's UI tax rate is tied to the unemployment claims paid to the prior employees of that employer. Experience rating requires UIA to trace UI benefits received by a worker to a particular employer.

Early each year, the UIA issues a Form 1771 (Tax Rate Determination for Calendar Year 2009). Form 1771 states the employer's prior actual reserve, benefits charged and contributions paid since the last annual tax rate determination, and the employer's new actual reserve. It also shows the employer's 12-month total and taxable payrolls, and the required reserve, as well as the employer's 60-month taxable payroll, and the benefit charges during that 60-month period. It then shows the calculated amount of each component of the employer's tax rate, and the employer's new UI tax rate.

Generally, in the first two years of an employer's liability, the UI tax rate is set by law at 2.7%, except for employers in the construction industry, whose rate in the first two years is that of the average employer in the construction industry which average construction rate is announced by UIA early each year. The rates in the third and fourth years of an employer's liability are based partly on the employer's own history of benefit charges and taxable payroll. This history is known as an employer's UI "experience". Beginning in the fifth year of liability, the UI tax rate is made up of three components which are computed separately and then added together to figure the yearly UI tax rate. The three components are the "Chargeable Benefits Component", the "Account Building Component", and the "Nonchargeable Benefits Component".

The Chargeable Benefits Component and the Account Building Component are affected by the employer's actual payroll, and the unemployment benefit charges to the employer's account. Since these components reflect each employer's experience, they are known as the "experience components", and the entire taxing computation is known as "experience rating".

For 2009, the maximum UI tax rate in Michigan is 11.05% (plus certain penalties but including the 0.75% "insolvency rate").

D. Reporting Requirements.

Once registered and determined liable under the MES Act, employers are required to provide wage detail information on a quarterly basis to the UIA for each covered employee paid wages during the calendar quarter. The Wage Detail Report may be submitted using any one of the following methods: (1) internet; (2) tape cartridge or (3) paper (UIA Form 1017).

E. Why Experience Rate?

1. Equity/Fairness. Employers who burden the system with layoffs and benefit payments are charged for the benefit payments.

2. Efficiency. Avoid subsidizing employers and industries that layoff many workers and support industries offering stable employment.

F. Experience Rating and State Unemployment Tax Act ("***SUTA***") Dumping.

Experience rating creates an incentive for some employers with bad layoff experience and a high UI tax rate to "dump" their tax liability on other employers, using one of three basic approaches:

1. "Vertical" SUTA Dumping. An employer creates a new entity (typically a limited liability company) that carries the new employer tax rate (2.7%) and transfers all or most of the employer's workers (and payroll) to the new entity.

2. "Horizontal" SUTA Dumping. An employer transfers some of its employees to an existing subsidiary entity with a better layoff experience and a lower UI tax rate.

3. "Transfer/Acquired Rate" SUTA Dumping. An employer transfers some of its employees to an existing employer with a better layoff experience and a lower UI tax rate, and the employees are then leased back to the former employer. The old entity continues to exist with the higher UI tax rate, but the old employer has little or no remaining payroll and therefore pays less UI tax.

G. 2008 Emergency Unemployment Compensation ("***EUC"***) Benefits. On June 30, 2008, President Bush signed the Federal Supplemental Appropriations Act (Public Law 110-252) which provides up to 13 weeks of EUC benefits to unemployed individuals. UIA has notified individuals by mail with instructions on how to apply for the EUC benefits. In Michigan, qualifying individuals may receive up to $362 a week in EUC benefits. Individuals who had a claim for regular benefits with a benefit year ending May 1, 2007 or later, which has been exhausted or has expired, may be eligible for up to 13 weeks of benefits. EUC applications cannot be filed after March 28, 2009, and no payments for EUC benefits will be made for any week beginning after June 30, 2009.

H. New Director of UIA. In July 2008 Stephen M. Geskey was named as the Director of the UIA. Prior to being appointed to head the UIA, Mr. Geskey chaired the Michigan Employment Security Board of Review. Prior to joining the Board of Review in 2005, he had been an Assistant Attorney General in the Michigan Attorney General's Office for eight years.

II. UIA'S PRIORITIES, PROCESS AND APPEALS.

A. Hot Issues.

- Protecting the solvency of Michigan's unemployment compensation fund. In 2008, the National Employment Law Project (***"NELP"***) identified Michigan as one of only four states (the others are Missouri, New York and Ohio) facing trust fund insolvency because of rising unemployment claims and short falls in employer contributions. According to NELP, Michigan's trust fund balance was only $31.1 million at the end of 2007. By comparison, at the end of 2007 Ohio's trust fund balance was $444 million and Illinois' was $1.8 billion.
- Enactment of legislation to bring the MES Act into compliance with the 2004 Federal Anti-SUTA Dumping Legislation. In August 2008, two bills (House Bills 6386 and 6387) were introduced in the Michigan Legislature.
- Detection of SUTA Dumping, including PEOs and Employee Leasing Companies ("***ELCs***").
- Transfers of Workforce and payroll among PEOs. The National Association of Professional Employer Organizations (***"NAPEO"***) estimates that approximately 2 to 3 million employees are employed by PEOs in the United States. According to the UIA, there are over 1,480 PEOs doing business in Michigan and many employees are moved among PEOs as SUTA dumps.
- UIA's "Unity of Enterprise" or Unit" theory to combine multiple employers into one "employing unit" under the MES Act.
- Detecting "Successor" Liability cases, business reorganizations, sales and other ***"Transfers of Business".***

- "Payrolling" or "Payroll Parking" (In exchange for the payment of a fee, two or more unrelated businesses agree to have all wages reported under the company with the lowest unemployment tax rate).
- "Buffering" transactions (An employer that anticipates downsizing forms a new subsidiary; moves/transfers its employees/payroll to the subsidiary; after a number of years the subsidiary lays off the employees and the subsidiary goes out of business).
- "Affiliated Shell Transactions" (An established employer with a high UI rate forms a subsidiary with a new UI rate; the subsidiary hires several new employees; the subsidiary pays UI taxes for a period of time at a lower/reduced UI tax rate; and the parent then transfers large amounts of its payroll to the subsidiary).
- "Purchase Shell Transactions" (A new company, without a previously assigned UI account number, purchases a company for the sole purpose of obtaining a lower UI experienced rate).
- Employee Misclassifications (Workers misclassified as "independent contractors" rather than as "employees").
- Under-Reporting of Payroll (Failures to report all employees or their wages).

B. UIA's Audit Priorities.

1. Detection by UIA:

   - U.S. Department of Labor's SUTA Dumping Detection System ("***SDDS***")
   - SDDS and information sharing with other States
   - Tips from competitors
   - Tips from disgruntled former/current employees

2. UIA's Resources:

   - Michigan's July 2005 Anti-SUTA Dumping legislation has had a profound impact on UIA's priorities and the use of its resources.

   - According to the U.S. Department of Labor's 2008 "Final Report" on the 2004 Federal Anti-SUTA Dumping legislation, "Michigan has enthusiastically pursued SUTA dumping…."

   - UIA conducts "SUTA Mondays" where auditors present the results of their SUTA audits to the UIA's executive SUTA review group.

   - The Michigan Attorney General's Office participates in the UIA's weekly SUTA Mondays and assists the UIA in developing and prosecuting its SUTA Dumping cases.

3. Investigation by UIA:

- UIA auditors and analysts meet with the employer's decision makers
- UIA requests and gathers documentation, including issuing subpoenas to employers
- The documents gathered include the following:

    - UIA Forms 1772 (Discontinuance or Disposition of Business or Assets)
    - UIA Forms 1027 (Business Transferor's Notice To Transferee of Unemployment Tax Liability And Rate)
    - UIA Forms 1184 (Employer's Report on Partial Transfer of Business)
    - UIA Forms 1184-1 (Report and Agreement on Partial Transfer of Business Certification)
    - UIA Forms 1045 (Status Questionnaire for Employee Leasing Companies)
    - UIA Forms 1045-A (Disclosure Statement for Employer Leasing/Client Companies with Common Officers/Ownership/Family Members)
    - Michigan Department of Treasury Form 518 (Registration for Taxes)
    - Schedule A (Liability Questionnaire)
    - Schedule B (Successorship Questionnaire)
    - IRS Forms 940 (Employer's Annual Federal Unemployment ["***FUTA***"] Tax Return)
    - IRS Forms 941 (Employer's Quarterly Federal Tax Return)
    - IRS Forms W2 (Wage and Tax Statement)
    - IRS Forms W3 (Transmittal of Wage and Tax Statement)
    - IRS Forms 8832 (Entity Classification Election)
    - IRS Forms 1120 (U.S. Corporation Income Tax Return)
    - IRS Forms 1120S (U.S. Income Tax Return for an S Corporation)
    - IRS Forms 1065 (U.S. Partnership Return of Income)
    - IRS Form 851 (Affiliated Company Schedule) attached to a corporation's IRS Form 1120. UIA obtains entity information when any subsidiary is located in Michigan.
    - IRS Form SS-4 (Application for Employer Identification Number). Newly issued federal EINs (derived from Forms SS-4 filed with IRS) may disclose new "employers" who should have registered for UI taxes and/or a SUTA Dumping transaction.
    - IRS Forms 1099-MISC. Multiple Forms 1099-MISC filed with the IRS may disclose taxable "wages" and that an employer is not registered for UI taxes.
    - Employer's e-mails and internal memos
    - Bills of Sale for transferred assets and businesses
    - Corporate minutes describing the formation of the new entity(s). New entities are typically formed as limited liability companies.
    - Bank account names and numbers for payroll and operating expenses
    - Notice of Coverage of Worker's compensation insurance coverage
    - Notice to employees of fringe benefits (such as health, life, disability and/or retirement benefits)

- ❖ Real estate and equipment leases between new entity(s) and former company
- ❖ Management/service agreements between new entity(s) and former company
- ❖ Telephone listings of new entity(s) and former company
- ❖ Internet Web domains of new entity(s) and former company
- ❖ Collective bargaining agreements ("***CBA***") with unions

4. <u>UIA Post-Investigative Conference with Employer and Its Advisors:</u>

- ➢ UIA's auditors and SUTA Dumping analysts ask the employer's executives, accountants and/or attorneys for admissions/comments regarding the UIA's factual and legal conclusions, such as:

  - ❖ Why did you set up the new entity(s)?
  - ❖ Who advised or assisted you in restructuring your business? Your accountant or lawyer?
  - ❖ What are the basis functions performed by each entity?
  - ❖ What is the basic goal or purpose of each entity?
  - ❖ How do these functions, goals and purposes contribute to the common goal or purpose of the other entities within the group or conglomerate?
  - ❖ For each entity, who owns the controlling interest in the entity?
  - ❖ For each entity, who are the Directors or managers?
  - ❖ Is the new entity disregarded for federal income and Michigan single business tax purposes?
  - ❖ What are the federal TINs of all of the entities?
  - ❖ How is the new entity a distinct and severable portion of the former company?
  - ❖ How is the new entity administered or managed?
  - ❖ How many employees (and what percentage of your total employees) were transferred to the new company? Why?
  - ❖ What company name(s) appear on invoices, payroll checks, bank accounts, contracts, letterhead, phone book, Internet web pages, etc?
  - ❖ Has the new entity obtained bank loans independently of the former company?
  - ❖ Other than SUTA taxes, which entity(s) report and remit quarterly income tax withholding and payroll taxes to the IRS, Michigan and cities?
  - ❖ Are retirement and fringe benefit packages handled differently after the change in business structure?
  - ❖ How are retirement and fringe benefits being handled now?
  - ❖ Were workers informed of the business restructuring?
  - ❖ Why don't these facts demonstrate a "transfer of business"?
  - ❖ **Why don't these facts demonstrate the employer's negligence or intentional disregard of the law?**

- Common Employer Explanations:

  - "Our lender requires that we separate our manufacturing business from our other business."
  - "The regulators in State X required that we separate our licensed employees from our unlicensed employees."
  - "The Michigan Department of Treasury allowed PEOs/ELCs to minimize single business taxes."
  - "We need to have separate accounting for possible litigation."
  - "We need to have separate accounting for the future sale of our business."
  - "Our union required that we separate our union and non-union employees"
  - "Our business purpose was ..…"

5. UIA Determinations and the Assessment of Taxes, Interest and Penalties:

- UIA will assess UI taxes, interest and penalties for all open tax periods.

- The statute of limitations for assessments is 3 years. See, MCL 421.15(j).

- The statute of limitations for refunds of UI taxes is also 3 years. See, MCL 421.16.

6. Administrative Appeals of Adverse UIA "Determinations":

- Appeals to SOAHR. Within 30 days after an adverse UIA "Determination," employers have the right to appeal the Determination to the State Office of Administrative Hearings And Rules ("***SOAHR***").

- Role of the Attorney General. The Michigan Attorney General's Office represents the UIA at the evidentiary hearing before the ALJ.

- Evidentiary Hearing. An Administrative Law Judge ("***ALJ***") will conduct an evidentiary hearing as to the legal and factual basis of the UIA's Determination. See, MCL 421.32a; MCL 421.33.

  - Discovery of Documents From the UIA. While the UIA resists disclosure of information in SOAHR proceedings [citing Section 54(d) of the MES Act; MCL 421.54(d)], Section 11 of the MES Act allows employers to obtain disclosure of "public records" from UIA pursuant to the Michigan Freedom of Information Act (***"FOIA***").

  - Discovery of UIA's Internal Policies. Documents to be disclosed by the UIA can include "confidential" documents that explain and disclose the UIA's internal policies regarding the interpretation and enforcement of the MES Act.

- ❖ Michigan Revenue Act and "Confidentiality" Cases.

  - *Newark Morning Ledger Co v Dep't of Treasury (*unpublished opinion of the Michigan Court of Appeals; docket No. 244733; May 27, 2004) (Under the Michigan Revenue Act, third party taxpayer information regarding the Department of Treasury's practices is not protected by the "confidentiality" provisions in Section 28(1)(f) of the Revenue Act).

  - *Bechtel Power Corp v Dep't of Treasury*, 128 Mich App 324, 331 (1983).

  - *International Business Machines Corp v Dep't of Treasury*, 71 Mich App 526 (1976) (Department of Treasury must redact identifying taxpayer names from Department's internal documents and then produce redacted documents for inspection).

- ➢ Appeals to Michigan Employment Security Board of Review. Within 30 days after an ALJ's adverse decision, employers (and the UIA) have the right to appeal the ALJ's decision to the Michigan Employment Security Board of Review. See, MCL 421.33(2); MCL 421.34 and 421.35.

  - ❖ Role of the Attorney General. The Michigan Attorney General's Office represents the UIA in the proceedings before the Board of Review.

  - ❖ No New Factual Record Created. The Employment Security Board of Review's consideration of an ALJ's decision is generally based solely on the factual record created by the employer and the UIA before the ALJ.

7. Litigation and Appeals to Michigan's Circuit Court:

- ➢ Employers and the UIA have the right to appeal an adverse decision by the Michigan Employment Security Board of Review to Circuit Court. See, MCL 421.38. The Michigan Attorney General's Office represents the UIA in the proceedings before the Circuit Court.

- ➢ Generally, an appeal to Circuit Court must be filed within 30 days of the Board of Review's adverse determination. See, MCL 421.38(1).

- ➢ Circuit Court review of the Board of Review's decision is based solely on the factual record created by the employer before the ALJ.

- ➢ The Circuit Court can only reverse the Board of Review if the agency decision is "contrary to law or is not supported by competent, material, and substantial evidence on the whole record." See, MCL 421.38(1).

8. Recent Cases Require Employers to Exhaust All Administrative Remedies Before Filing Suit in State Court.

- American Employers Group, Inc. v California Employment Development Department (California Court of Appeals, Case No. B193338; 2008). The California Employment Development Department ("***EDD***") imposed a $27 Million "unity of enterprise" determination on an employer. EDD claimed that a group of companies were one "employer" under California's anti-SUTA Dumping law. While pursuing an administrative appeal, the employer also filed a law suit in California state court for an order rejecting the EDD's retroactive application of its unity of enterprise theory to the employer. On appeal, the California Court of Appeals held that the employer had to exhaust its administrative remedies before filing suit in California state court. The court held that, after the employer's administrative appeal was concluded, the merits of EDD's unity of enterprise determination would be subject to judicial review.

- CPE HR Inc. v California Employment Development Department (California Court of Appeals, case No. C055219; 7/31/08). The California EDD issued a determination that CPE PEO, Inc. and 12 associated business entities were one employing unit under California's anti-SUTA Dumping law. The EDD issued an adverse "unity of enterprise" determination in the amount of $49 million. The employer objected to the retroactive application of the EDD's unity of enterprise determination and argued that certain tax years were closed because the statute of limitations on assessments had expired. The employer filed suit in state court. The trial court dismissed the employer's suit on the ground that the plaintiffs had failed to exhaust their administrative remedies. In affirming the dismissal of the employers' law suit, the Court of Appeals ruled: "Under the exhaustion [of remedies] doctrine, CPE must exhaust all of the administrative procedures available to it before it can seek judicial review of the limitations issue…."

III. FEDERAL SUTA DUMPING PREVENTION ACT OF 2004.

A. Introduction. The SUTA Dumping Prevention Act [Public Law 108-295; 42 USC 503(k)] (the "***Federal Act***") was enacted on August 9, 2004.

The Federal Act amended section 303(k) of the Social Security Act (***"SSA"***) to establish a minimum nationwide standard for curbing SUTA Dumping. Section 303(k) required all States to amend their UI laws by 2006 to prohibit certain types of SUTA Dumping, including "affiliated shell transactions" and "purchased shell transactions".

According to Congress, SUTA Dumping harms the federal government, employers, states and workers. SUTA Dumping conflicts with the fundamental tenet of the experience-rated UI tax system, creates an unfair competitive cost advantage for employers that use SUTA dumping schemes, and disadvantages those employers who try to manage their work and maintain steady employment for their employees. SUTA dumping also reduces money in state unemployment compensation trust funds, causes overall increases in employers' taxes, and the loss of discounts to employers that are triggered when state fund balances reach certain levels. SUTA Dumping also reduces the funds available to pay unemployment benefits to unemployed workers.

1. 2008 U.S. Department of Labor's Final SUTA Dumping Report (Paper 2008-05).

According to the Department of Labor's 2008 "State Unemployment Tax Act Final Report" on the 2004 Federal Act:

- Most States' have not been successful in assessing penalties on employers and their advisors for "intentional" acts of SUTA Dumping.
- There is little agreement or consensus among the States regarding whether or not PEOs should be treated as the "employer" for unemployment purposes. Currently, 36 states permit PEOs to be the "employer" and report the client's payroll under a PEO account. 17 States currently require PEOs to report payroll under the client account.
- While PEOs are treated as the "employer" for experience rating purposes under the MES Act and Michigan Rule 190, the UIA has stated that, from a policy perspective, the client company (and not the PEO) should be considered as the "employer" and that all tax reports should be submitted under the client's account numbers. UIA has also stated that unemployment experience should be transferred between a client company and a PEO when entering and existing a contractual relationship.

B. Federal SUTA Dumping Regulations. The U.S. Department of Labor, Employment and Training Administration has issued two sets of regulations (in a question and answer format) under the Federal Act. See, Vol. 69, No. 187 Federal Register page 58550 (September 30, 2004), and Vol. 69, No. 219 Federal Register page 65654 (November 15, 2004).

C. Transfers of Only Employees Under the Federal Regulations. The U.S. Department of Labor Regulations make clear that the transfer of only employees from one entity to another entity can constitute SUTA Dumping. The federal Regulations state:

> "The transfer of some or all of any employer's workforce to another employer shall be considered a transfer of trade or business when, as the result of such transfer, the transferring employer no longer performs trade or business with respect to the transferred workforce, and such trade or business is performed by the employer to whom the workforce is transferred.
>
> Care should be taken to assure the state law does not require transfers of experience where an employee is 'moved' from one employer to another, without any transfer of trade or business, See Q & A 1-7…" (November 8, 2004 Regs, Question & Answer No. 1-2).

D. Substantially Common Ownership, Management or Control Under the Federal Regulations. The federal Regulations also take a broad view of what "substantially common ownership, management, or control" means under the Federal Act. The Regulations state:

> "[T]he Department is not defining a 'bright line" test of what constitutes 'substantially common ownership, management, or control.' …Therefore, 'substantially' **could include less than 50%** common ownership, management, or control. 'Substantial' common management, for example, might even occur where Company A and Company B share only one manager, but that one

manager exercises **pervasive control** as the chief executive officer of both companies." (November 8, 2004 Regs, Question & Answer No. 1-3) (emphasis added)

IV. MICHIGAN'S 2005 ANTI-SUTA DUMPING LEGISLATION.

A. Michigan Anti-SUTA Dumping Legislation. In response to the Federal Act, effective on July 1, 2005 the Michigan Legislature adopted anti-SUTA dumping legislation (2005 Public Acts 16, 17, 18 and 19) (collectively, the "***Michigan Acts***"). The Michigan anti-SUTA Dumping Acts amended the MES Act to do all of the following:

- Prohibit a person from transferring all or part of a trade or business solely or primarily for the purpose of reducing an employer's contribution rate or reimbursement payments in lieu of contributions required under the MES Act (i.e., SUTA Dumping).

- Prohibit a company from acquiring all or part of a trade or business solely or primarily to obtain a lower contribution rate than otherwise would apply under the MES Act.

- Require that the UIA use objective factors to make the foregoing determinations, such as the cost of acquiring the business, continuing in operating the business enterprise of the acquired business, the length of time the business enterprise continues to operate, and the number of new employees hired to perform duties unrelated to the business activity or trade conducted before the acquisition.

- Prescribe sanctions and penalties against persons who knowingly violate or attempt to violate the Michigan Act.

- Require the UIA to recalculate the contribution rates of both employers if an employer transfers its trade or business to another employer and there is substantially common ownership, management or control of the two employers.

- Require the UIA to assign a new employer contribution rate to a person who is not an employer under the MES Act at the time of a transfer and who acquires a trade or business solely or primarily to obtain a lower contribution rate.

- Require that money recovered under these provisions be credited by UIA to the Michigan Unemployment Compensation Fund.

- Require the UIA to report annually to the Legislature regarding SUTA Dumping.

- Establishes requirements concerning the payment of a balance, the transfer of benefit charges, and the continuation of reimbursement payments, that apply to a change in status between reimbursing employer and contributing employer.

B. No Special Treatment for PEOs. The Michigan Act does not specifically address SUTA Dumping attributable to PEOs and/or ELCs.

PEOs are independently established businesses that provide employees to a client entity. Typically, the client transfers its workers (and their related payroll) to the PEO who then leases the workers back to the former employer. If the transfer of workers to the PEO is respected by UIA and PEO has a lower UI tax rate than its client, SUTA taxes will have been minimized.

According to Department of Labor and Economic Growth ("***DLEG***"), approximately 60% of the shortfall in the Michigan unemployment compensation fund is due to employers that use PEOs to avoid paying their full share of unemployment taxes.

C. Pre-July 2005 MEA Act Bars SUTA Dumping. The UIA has been asserting in audits that the pre-July 2005 MES Act prevents SUTA Dumping, including the transfers of workers by employing units to PEOs and ELCs. See, Pre-July 2005 MCL 421.22(a), (b) and (c) [each subsection deals with the "deemed" "transfer[s] of business" by an employer].

D. Retroactive Application of the Michigan Act by UIA. The UIA appears to be applying post-July 2005 Section 22b [MCL 421.22b(6) (2005 P.A. 18)], as well as the related Anti-SUTA dumping legislation (i.e., 2005 P.A. 16, P.A. 17 and P.A. 19), to tax years prior to the July 1, 2005 effective date of the Michigan legislation.

Michigan appellate courts have not yet determined whether (1) the Legislature intended that the July 2005 legislation be applied retroactively, and, if so, (2) whether it is constitutional for UIA to apply the legislation to tax years prior to the July 1, 2005 effective date of that legislation.

E. Penalties for Violating the Michigan Act. No penalties are associated with merely moving employees from one employer to another, even if both employers are under substantially common ownership, management or control. If, however, a transferring or acquiring employer knowingly violates or attempts to violate the prohibitions set forth in MCL.22b(1), then the employer will be assigned the higher of the following UI contribution rates:

1. The highest contribution rate assignable under the Michigan Acts for the rate year during which the violation or attempted violation occurs and for the three rate years immediately following that rate year (currently 10.3%), or

2. If the employer's business is already at the highest rate assignable for a year in which the violation occurs or if the highest rate assignable would result in an increase of less than 2% of taxable wages, an additional penalty rate of 2% of taxable wages for that year.

3. The Michigan Acts (MCL 421.22b(5)(a)) define "knowingly" as "having actual knowledge of, or acting with deliberate ignorance or reckless disregard for, the prohibition involved."

4. In addition, penalties may be imposed for the underpayment of employment taxes, negligence (5% penalty), intentional failure to comply with the MES Act (5% penalty), fraud (50% penalty) and/or for the making of a false statement or willful and knowing failure to disclose a material fact.

5. The penalty imposed for a willful violation or intentional failure to comply is equal to tax avoided plus damages equal to three times that amount and may include criminal prosecution. See, MCL 421.54(a)(i) and (ii).

6. The penalty imposed for making a false statement or the knowing and willful failure to disclose a material fact is equal to the tax avoided plus damages equal to four times that amount and may also include criminal prosecution. See, MCL 421.54(b)(i) and (ii).

7. If a person knowingly violates or attempts to violate P.A. 18's prohibitions, or if a person knowingly advises another person in a manner that causes a violation, a civil fine of up to $5,000 may be imposed.

8. These penalties are in addition to any sanction available under Section 54(b) or 54b of the MES Act. Section 54(b) prescribes civil and criminal penalties for certain violations involving false statements made knowingly or within the intent to defraud.

F. Michigan Legislature's 2005 Intent. The Michigan Legislature intended the 2005 Michigan Acts "to be interpreted and applied in a manner so as to meet the **minimum requirements** of the SUTA Dumping Prevention Act of 2004, Public Law 108-295, and implementing federal regulations." (emphasis added) (2005 P.A. 18; MCL 421.22b(6)).

1. Michigan's Alleged Non-Compliance with Federal Anti-SUTA Dumping Act. On October 26, 2006, the U.S. Department of Labor informed UIA that Michigan was not in compliance with the requirements imposed on States by the 2004 Federal Act.

The U.S. Department of Labor objected to the UIA's interpretation of Section 22b of 2005 PA 18. According to the U.S Department of Labor, UIA interprets Michigan law "to only mandate the transfer of experience between entities with substantial commonality when the [UIA] can demonstrate that the employer made the transfer of trade or business "solely or primarily" to obtain a lower rate of contribution". The U.S. Department of Labor's position is that: "Section 303(k) of the [Social Security Act], provides that [Michigan] state law must provide that experience shall be transferred when there is a transfer of trade of business and the entities have substantial commonality."

On August 20, 2008, legislation was introduced in the Michigan Legislature at the behest of the UIA to modify Michigan's 2005 anti-SUTA Dumping legislation to bring Michigan's law into compliance with the Federal Act.

G. 2008 Proposed Michigan Legislation – House Bills 6386 and 6387.

According to the UIA, HB 6386 and HB 6387 have significant revenue implications to the State of Michigan because Michigan law does not currently conform with the Federal Act. By failing to comply with the Federal Act, Michigan risks losing federal funding for the administration of Michigan's UI program. For the 2008-2009 fiscal year, the federal grants at risk could be approximately $136 million. Additionally, Michigan's conformity with the Federal Act is necessary to enable Michigan employers to receive credit against federal FUTA taxes that effectively reduces the FUTA rate from 6.2% to 0.8% on taxable wages paid to Michigan employees.

1. HB 6386 (passed House of Representatives on 9/24/2008) To Revise Michigan's 2005 SUTA Dumping Law.

HB 6386 [amending MCL 421.22b] would rewrite the definition of "SUTA Dumping" to mean either (a) transferring all or part of a trade or business in a manner that results in a violation of the MES Act; or (b) acquiring all or part of a trade or business, solely or primarily for the purpose of reducing the contribution rate or reimbursement payments in lieu of contributions required under the MES Act.

It appears that, if enacted, HB 6386 would be retroactive to at least January 1, 2006. See, HB 6386(6)("Beginning January 1, 2006, …")

Section (5) of HB 6386 specifically declines to grant authority to the UIA to promulgate rules defining "SUTA Dumping."

Section (10) of HB 6386 states:

> "This section is intended to be interpreted and applied in a manner so as to meet the **minimum requirements** of the SUTA dumping prevention act of 2004, Public Law 108-295, and implementing federal regulations." (emphasis added)

Under House Bill 6386, if an employer transfers its trade or business, or a portion of it, to another employer and there is substantially common ownership, management, or control of the two employers at the time of the transfer, the unemployment experience attributable to the transferred trade or business would be transferred to the transferee employer. The UIA would recalculate the contribution rates of both employers and apply the new rates in the same manner as for a transfer of business under the MES Act, and the employers' experience accounts would be combined into a single account and a single rate assigned to the account.

If the UIA determines that a person who is not an employer under the MES Act at the time of a transfer acquires a trade or business, or a portion of a trade or business, solely or primarily for the purpose of obtaining a lower contribution rate, the UIA would not transfer the unemployment experience but would have to assign that employer the applicable new employer rate (2.7%) under the MES Act.

If a person knowingly transfers or acquires, attempts to transfer or acquire, or advises a person to transfer or acquire a trade or business or a portion of a trade or business to obtain a reduced contribution rate or reimbursement payment in lieu of contributions required under the MES Act, that person would be subject to the following sanctions:

- A person who is not a transferring or acquiring employer would be subject to a civil fine up to $5,000.
- If the person is a transferring or acquiring employer, the employer would be assigned the higher of the following contribution rates:

  - ❖ The highest contribution rate assignable under the MES Act for the calendar year during which the violation or attempted violation occurred and for the 3 calendar years immediately following that rate year.

  - ❖ If the employers' business already is at the highest rate assignable for a year in which the violation occurs, or if the highest rate assignable would result in an increase of less than 2% of taxable wages, then the employer would be assigned an additional penalty rate of 2% of taxable wages for that calendar year and for the 3 calendar years immediately following that calendar year.

All money recovered under HB 6386 would be paid to the Michigan Unemployment Compensation Fund.

2. <u>HB 6387 (passed House of Representatives on 9/24/2008) Amends MES Act to Regarding the Disclosure of Unemployment Insurance Information.</u>

Generally, the MES Act provides that information obtained from employers and individuals is confidential and not subject to disclosure or public inspection, except in certain limited circumstances. According to its sponsors, HB 6387 would amend the disclosure provisions of the MES Act [MCL 421.11] to be consistent with federal regulations (20 CFR 603) and U.S. Department of Labor directives.

The MES Act permits disclosure of otherwise confidential information to a college, university, or state agency conducting research of a "public service nature." HB 6387 specifies that the release of confidential information could be made to a college, university, or state agency conducting research in certain circumstances. HB 6387 would require the UIA to enter into a written agreement ensuring the confidentiality of the information provided. If the agreement is violated, the agreement would be terminated and the public official would be subject to the penalties of 90 days imprisonment and/or a fine of $1,000.

Section 11(6) of HB 6387 would prohibit recipients of confidential information from releasing such information without obtaining the prior approval from the UIA or from using the information received in a manner inconsistent with the written disclosure agreement with the UIA.

HB 6387 would also clarify that information could not be disclosed in a manner that reveals particular identifying information about an individual or past or present employer.

HB 6387 would specify that disclosure of confidential information is permitted in the following circumstances:

- To agents of "interested parties" if the agent provides the UIA with a written authorization or representation from the represented party.
- To attorneys retained for purposes related to a claim for unemployment insurance benefits, upon the attorney's assertion that the he or she represents the interested party.
- To elected public officials in the performance of constituent services, if the official provides evidence that the constituent authorized the disclosure.
- To other third parties (not acting as agents), if the third party presents a release from an interested party. The release would have to be signed by the interested party, specify the information to be released; list the individuals who may receive the released information; state the specific purpose for which the information is sought. The purpose of the release would be limited to providing a service or benefit to the individual subject to the release or in administering or evaluating a public program related to the release.

V. FEDERAL SUTA DUMPING DETECTION SYSTEM.

A. Introduction. The Federal SUTA Dumping Detection System ("***SDDS***") is a PC-based computer system developed by North Carolina in cooperation with the U.S. Department of Labor. The SDDS was developed to detect employer attempts to artificially lower their UI tax rates. At least 44 States are currently using the SDDS system. The SDDS system became operational in Michigan in September 2005.

B. The SDDS System is a Powerful Anti-SUTA Dumping Tool. The States use various criteria or filters to search the SDDS databases. Employee payroll information and data on all employers who report information to their home states and their quarterly (and/or initial) reports are uploaded into the SDDS system. SDDS is designed to aid States in tracking and auditing various kinds of SUTA activities.

The SDDS system enables states to conduct elaborate computer searches using criteria to monitor employer compliance with federal and state SUTA laws, including the following:

- The movement of employees from one employer to another employer
- Employer UI tax rate changes (for example, from a higher UI rate to a lower UI rate)
- Employer tax rate histories
- Employer contact information
- Employer demographics (for example, multiple companies using the same TIN numbers, phone numbers, names and social security number of the owner(s) of employers, UI taxes paid, benefits charged, and number of employees employed by quarter)

- Worker demographics (for example, employee social security numbers, taxable wages, benefits claimed, dates of birth, education levels, genders, addresses, race and ethnicity).
- Top employers by growth rate (measured by number of employees and payroll)
- Top employers by benefit charges
- Top employers by total wages with no taxable UI wages

VI. UIA'S "VOLUNTARY" SUTA COMPLIANCE PROGRAM.

The UIA has established a "voluntary"/quasi-amnesty SUTA Dumping program. According to the UIA, employers who "suspect that [they] may have been involved in a SUTA dumping plan … may avoid or reduce potential penalty and/or interest charges by voluntarily coming forward and contacting UIA…"

To "voluntarily" take part in a SUTA review, the employer must complete and file a UIA Form 1945 (Application For SUTA Dumping Program).

VII. SUTA DUMPING AND "DEEMED" "TRANSFERS OF BUSINESS" UNDER THE MES ACT.

A. UIA's Position. Section 22(c) of the MES Act [MCL 421.22(c)] is often cited by the UIA to determine that an employer is a taxable "successor" entity to one or more prior employers.

B. Section 22(c) of the MES Act. Prior to the July 2005 Michigan legislative amendments, Section 22(c) read in full as follows:

> "(c) Notwithstanding any other provisions of this section, if an employer subject to this act transfers subsequent to December 31, 1973, any of the assets of his business, by any means otherwise than in the ordinance course of trade, to any transferee or transferees ***substantially owned or controlled, in whole or major part***, either directly or indirectly ***by legally enforceable means or otherwise***, by the same interest or interests which ***owned or controlled the transferor*** at the time of such transfer, such transfer shall be ***deemed a 'transfer of business'*** for purposes of this section." (emphasis added)

C. Judicial Standard for "Control" Under the MES Act. In *Godsol v Unemployment Compensation Commission*, 302 Mich. 652 (1942), the Michigan Supreme Court explained what is meant by the term "control" under the MES Act. The Michigan Supreme Court adopted the rule announced by the Maine Supreme Court in *Maine Unemployment Compensation Commission v Androscoggin Junior, Inc.*, 137 Me 154, 16 Alt. 2d 252**.**

In *Godsol* the Michigan Supreme Court said:

> "In our opinion the language of the statute is clear. It does not require legally enforceable control. It states that an employer under the act would be any employing unit 'which owns or controls one or more other employing units (by legally

enforceable means or otherwise).' … [Quoting the Maine Supreme Court], The control required is not necessarily that legally enforceable. It may be otherwise. **It is a matter of actual control. *** Taking all the facts into consideration,** * * * it is but natural to conclude that they regarded him as **the one whose voice in the conduct of the company's affairs should govern.** We find that he controlled this corporation within the meaning of the statute.'" 302 Mich 661-662 (emphasis added).

In *Godsol* the Michigan Supreme Court addressed the 1940 version of Section 41(3) of the MES Act. In the Court's words:

> "Section 41(3) of the unemployment compensation act as amended in 1937 [citation omitted] provides:
>
> 'Any employing unit which, together with one or more other employing units, is **owned or controlled (by legally enforceable means or otherwise) directly or indirectly** by the same interests, or which **owns or controls** one or more other employing units **(by legally enforceable means or otherwise)** and which, if treated as a single unit with the such other employing units or interests, or both, would be an employer under paragraph (one) of this section.'" (emphasis added)

D. Whose "Voice" Controls the Company's Affairs? Under *Godsol*, after taking all of the facts into consideration, the key is to determine the one person whose "voice in the conduct of [the employer's] affairs … govern[s]". According to *Godsol* that is the person who is in "control" under Section 22(c) of the MES Act.

E. Penalties. UIA routinely assesses the 5% negligence penalty and interest under, respectively, Section 15(a), (g) and (h) of the MES Act in circumstances where the taxpayer fails to properly report "transfers of business", including the transfer or reassignment of employees. These penalties can be abated/waived by the UIA.

VIII. UIA'S "UNITY OF ENTERPRISE" THEORY -- EMPLOYER COMBINATIONS & SINGLE "EMPLOYING UNITS" UNDER THE MES ACT.

A. UIA's "Unity of Enterprise" Theory. The UIA relies upon Sections 14, 19 and 40 of the MES Act [MCL 421.14, .19 and .40] to determine that a group of entities, often times multiple PEOs, should be combined as a "single" "employing unit" under the pre-2005 Michigan legislation.

When the UIA applies the Unity of Enterprise Theory to a group of related or affiliated business entities, the effect is that the separate existence of the corporations, partnerships, etc. are ignored by the UIA for employment tax purposes.

B. Section 40 of the MES Act. Prior to the July 2005 Michigan Anti-SUTA Dumping legislation, Section 40 of the MES Act read as follows:

> "'**Employing unit'** means any individual or type of organization, including, but not limited to, a governmental entity as defined in section 50a, a partnership, association, trust, estate, joint-stock company, insurance company or corporation, whether domestic or foreign, or the receiver, trustee in bankruptcy, trustee or successor thereof, or the legal representative of a deceased person, which has or subsequent to this amendatory act, had

in its employ 1 or more individuals performing services for it within this state. All individuals performing services within this state for any **employing unit** which maintains 2 or more separate establishments within this state shall be considered to be employed by **a single employing unit for all the purposes of this act**. Each individual employed to perform or to assist in performing the work of any agent or employee of an employing unit shall be considered to be employed by that employing unit for all the purposes of this act, whether the individual was hired or paid directly by that employing unit or by the agent or employee, provided the employing unit had actual or constructive knowledge of the work."

C. Michigan Supreme Court Cases Reject UIA's "Unity of Enterprise" Theory. The Michigan Supreme Court has previously announced the criteria that apply in determining the circumstances when a group of commonly owned and controlled entities can be treated as single "employing unit" under Section 40 of the MES Act.

1. ***Schusterman v. Employment Security Commission***, 336 Mich 246 (1953).

In *Schusterman* a husband and wife were the sole shareholders of two corporations except for a small number of shares of stock owned by the federal housing administration. Citing the testimony of the corporations' accountant, the Court found that the accounts of the corporations had been kept separately; that separate invoices had been issued by the corporations to their tenant/customers; that separate bank accounts had been maintained by each of the corporations; and that avoidance of employment taxes was not the business purpose for the owners' conduct of the their business through the two separate entities After reviewing these facts, the Supreme Court specifically rejected the Employment Security Commission's attempt to use Section 40 to combine the two entities into a single "employing unit".

The Court said:

"The gist of the [Employment Security] commission's claim is that the 2 companies, although separate and distinct in every respect, are only 1 employing unit under the employment security act. In *Ned's Auto Supply Co.* v. *Unemployment Compensation Commission*, 313 Mich 66, four brothers and a sister comprised the members of a partnership. They dissolved the partnership and organized 2 corporations for the purpose of conducting the wholesale and retail phases of the same business. The 2 companies sought to combine its experience record with that of its predecessor partnership for the purpose of determining its rate of contribution….

[Quoting *Ned's Auto Supply* the Supreme Court said] **[w]e cannot agree with this argument, because plaintiff corporations are 2 separate and distinct legal entities and, therefore, 2 separate employers.** We recognize that the courts have often looked through the veil of corporate structure in order to prevent fraud or injustice. [citations omitted] However, no question of fraud is involved in the present case, and we find no occasion to disregard the corporate entities of the 2 plaintiffs. A single partnership had been split into 2 separate corporations, and under section 22 quoted above they could not be combined as a 'single' successor employing unit." *Schusterman,* at pages 257-258 (emphasis and material in brackets added)

The Court in *Schusterman* stated its holding as follows:

"It is a well established fact that a corporation is a separate entity, separate from its individual stockholders. In the case at bar, the 2 projects were designed as 2 separate entities on the recommendation of the Federal housing administration. **There was no plan of avoidance of contributions to the Michigan unemployment compensation fund.** The accounts and records of the company were kept separately.

We are in accord with appellants' claim that under the circumstances of this case, **there was a sound business reason for the separation of the 2 companies**. The 2 companies do not constitute a single employing unit under the unemployment compensation act. Each was a separate and distinct unit." Id., at 260. (emphasis added)

2. ***Employment Security Commission v. Crane,*** 334 Mich 411 (1952).

In the *Crane* case the Supreme Court dealt with the issue of whether two partnerships owned and controlled by the same two individuals could be treated as a single employing unit under Section 40 of the MES Act. In this case the two individuals were partners in a tractor sales and service business and also a Ford sales and service business. The two partnerships maintained separate books of account; maintained separate bank accounts; operated under separate franchises from different manufacturers and distributors; employed separate employees; used separate letterheads; issued separate billings to their customers; and filed separate federal income tax returns.

In rejecting the Employment Security Commission's efforts to combine the entities into a single "employing unit" under Section 40, the Court said:

"[W]e do not find in the employment security act itself any requirement that 2 separate and distinct copartnerships operating as in the case at bar must be construed as a single employing unit. Appellant's only basis for claiming such a conclusion must be found solely in the unity of the partners in both copartnerships. There is no such "unity of enterprise" here as to bring the instant case under *American Screw Products Co.* v. *Michigan Unemployment Compensation Commission*, 311 Mich 440 (159 ALR 1195). Here, the enterprises operated by the 2 partnerships were fully separate and apart, and conducted as such." *Id*, at 418. (emphasis added)

The Supreme Court added:

"In the instant case, the two Johnsons had a **sound business reason** for the complete separation of the Johnson Tractor & Implement Sales partnership from the Ford agency partnership. The Johnson Tractor & Implement Sales agency operated under a franchise from its supplier prohibiting it from engaging in any other business. Section 41 …recognizes that legal entities are not to be disregarded unless it appears that there is **no sound business reason** for separation **other than merely to avoid contributions under the act.** The reason for the separation here has not been challenged." *Id.*, at pages 419-420 (emphasis added).

3. ***Bell-Lourim Electric Supply Company v. Employment Security Commissio****n*, 346 Mich 627 (1956).

In *Bell-Lourim* the Supreme Court addressed the question of whether two corporations that received the assets and employees of a dissolved partnership were a single employing unit under the MES Act. The two corporations were owned and managed by the same persons. The corporations maintained their own records; filed separate tax returns; and maintained separate pay rolls for their, respective, employees, many of whom were the same employees previously employed by the dissolved partnership. A number of the employees were simultaneously employed by both corporations. The two corporations occupied the same office space and shared the costs of the office space and utility bills. Citing its earlier opinion in *Schusterman*, the Court rejected the corporations' claim that the separate corporations could be combined as a single "employing unit" under the MES Act. *Id.*, at page 638.

D. Michigan Court of Appeals Rejects UIA's "Unity of Enterprise" Theory.

1. ***M & M Aerotech, Inc. v. Department of Treasury,*** Michigan Court of Appeals (docket No. 211460; November 23, 1999) (unpublished opinion).

In *M & M Aerotech*, the Michigan Court of Appeals applied the Supreme Court's 1953 ruling in *Schusterman* and rejected the Michigan Department of Treasury's attempt to combine two corporate entities as a single taxpayer. In so doing, the Court of Appeals said "[I]t is well-established that a corporation is an entity separate from that of its individual shareholders, officers, and directors [citing the *Schusterman* case], and defendant has neither briefed nor provided authority to support its suggestion that both corporations should be regarded as a single unit in this case."

E. SOAHR ALJ Decisions Reject UIA's Unity of Enterprise Theory.

1. *BCN Administrative Services*, (SOAHR Appeal Docket No. L200500049)(April 4, 2007) (appeal pending before the Michigan Employment Security Board of Review). SOAHR Administrative Law Judge ("***ALJ***") accepted taxpayer's business purposes (tax planning and insurance planning) for years 1999 to 2002 and rejected UIA's position that the taxpayer engaged in "fraudulent" conduct during these years. The UIA approved UIA's position for tax year 2003. The UIA has appealed the ALJ's decision to the Employment Security Board of Review. By a Removal Order dated September 21, 2007, the Board of Review took jurisdiction of all proceedings in the BCN case.

2. *Preferred Home Brokers Service*, (SOAHR Appeal Docket No. L200700027)(July 20, 2007). Based upon an individual's ownership, Presidency and control of three corporations, ALJ affirmed a UIA determination which had found that Preferred Home was the "successor" to a prior company pursuant to Sections 41(2) and 22(c) of the Employment Security Act.

3. *Crown Services Compan****y***, (SOAHR Appeal Docket No. L200600039) (July 24, 2007). The ALJ modified a UIA determination for years 2000 to 2005. In doing so, the ALJ rejected the UIA's position that related PEOs must use only one UI account number. The ALJ said:

"**Initially, it should be stated that the [UIA] argument for consolidation of all of the accounts into one account is expressly rejected.** For years, the Agency has been aware of the PEO Industry and the potential impact on UA. The addition of new account numbers for this and other multiple PEO employers has long been accepted by Agency practice. In the absence of specific abuses, the broad sweeping approach of combining all related PEOs into one account number to respond to specific alleged abused cannot be sustained." (emphasis added)

F. Michigan Court of Appeals Rejects UIA's "Successorship" Theory Under Section 41(2) of the MES Act.

1. ***Midwest Rubber Company v Unemployment Insurance Agency,*** Michigan Court of Appeals (Docket No. 278223; December 18, 2008) (unpublished opinion).

Court of Appeals affirmed a Circuit Court ruling that a purchaser was not a "successor" to a prior company under Section 41(2) [MCL 421.41(2)] of the MES Act. In rejecting the UIA's successorship theory, the Court of Appeals' relied upon its 1994 decision in *K & K Woodworking v MESC*, 206 Mich App 515 (1994).