

HUMAN RESOURCES

A human resources management tool
for small and medium-size companies.

What a PEO Can Do for You

BY BRUCE E. KATZ

EXECUTIVE SUMMARY

- **MORE THAN EVER BEFORE, BOTTOM-LINE-CONSCIOUS** companies are outsourcing HR functions by making use of professional employer organizations. PEOs perform a wide variety of tasks ranging from payroll management and employee benefit design and administration to tax filings and compliance with state and federal workplace legislation.
- **GIVEN THE MYRIAD TASKS THEY PERFORM, PEOs** are recognized as coemployers since they assume certain legal rights and duties related to employee performance. The rights and duties are outlined in a contract between the PEO and the client company.
- **THE IRS CONSIDERS THE PEO TO BE THE EMPLOYER** of record and as such responsible for paying trust fund, income and employment taxes. State rules vary. A prospective PEO client should familiarize itself with its state's position on unpaid employment and unemployment taxes in a PEO relationship.
- **THE MOST ATTRACTIVE ADVANTAGE A COMPANY GAINS** when entering into a PEO relationship is the ability to offer employees a much wider selection of benefits, often at considerably lower cost. Due to the large number of employees, PEOs and their clients enjoy the economies of scale usually reserved for only the largest employers.
- **IN SELECTING THE RIGHT PEO, COMPANIES SHOULD** consider factors such as the PEO's ability to offer core services, its stable financial history, an experienced staff of HR specialists and a track record with companies of similar size and industry.

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More than ever before, CPAs are advising their bottom-line-conscious employers to use outsourcing to cut costs and improve efficiency. Once confined to production-related areas, outsourcing has grown to encompass a broad range of business operations. Human resources and payroll are two areas companies traditionally kept within their control, but over time businesses have gradually begun to outsource payroll functions to service bureaus and turn over more employee-related responsibilities to professional employer organizations (PEOs). CPAs and other financial executives whose employers do not already use PEOs should understand how they work—and how to select the right one—so they can decide whether the PEO route is a good solution for their companies.

PEOs specialize in human resources (HR) management. They offer businesses a wide variety of services—including payroll management, employee benefit design and administration, tax filing and administration and compliance with state and federal workplace legislation. PEOs also take responsibility for developing and administering lawful employment policies and procedures; employee recruitment and disciplinary actions; recordkeeping; and unemployment, disability and workers' compensation claims and administration.

According to the SBA, PEOs control a 2% market share of the payrolls of small to medium-size companies (those with fewer than 100 employees). Many different types of companies use PEOs, since the benefits of doing so cut across industry lines. With the number of employees working for PEOs projected to grow at 30% per year, more and more CPAs may find themselves recommending that their companies consider using PEOs as their HR departments.

The PEO Industry

There are more than 1,000 professional employer organizations nationwide, with 2 million to 3 million employees. Their collective payrolls are estimated at \$18 billion.

Source: National Association of Professional Employer Organizations, Alexandria, Virginia.

FROM EMPLOYEE LEASING TO PEO

In the 1970s, a safe-harbor provision in federal tax legislation enabled companies to maintain pension plans for management and key employees that differed from those for regular staff employees—provided the staff employees were leased. Although that safe harbor disappeared in 1982 with the passage of the Tax Equity and Fiscal Responsibility Act, the trend it established toward employee leasing continued. Leasing companies extended their services to encompass the entire HR area, leading to the birth of the PEO.

PEOs now perform myriad tasks. Some states recognize them as “coemployers” since they assume certain legal rights and duties related to employees who work at client locations. (The IRS does not use the term coemployer—it recognizes PEOs as employers.) The rights and duties PEOs assume are set forth in a contract between the PEO and

the client company. Typically, a PEO's responsibilities include the general aspects of the employer's role—for example, paying employee wages and associated withholding taxes. (The PEO is responsible for paying these taxes whether or not the client actually pays the PEO.) The PEO also must provide employees with workers' compensation, federal and state unemployment and statutory disability coverage. In addition, the PEO administers any employee benefit programs including retirement plans; cafeteria and health care plans; life, disability, accidental death and dismemberment insurance; credit unions; fitness club memberships; child care; and tuition reimbursement programs.

When a PEO sponsors employee benefit plans, it assumes fiduciary responsibility for plan compliance with applicable federal and state laws. When a client company decides to maintain its own employee benefit plan, the company continues to have fiduciary responsibility as well as plan testing, filing and other obligations it might otherwise avoid through a PEO.

The High Cost of Employees

The average annual cost of regulation, paperwork and tax compliance for companies with fewer than 500 employees is about \$5,000 per employee. For companies with more than 500 employees, the cost is about \$3,400 an employee.

Source: Small Business Administration.

In most circumstances, the PEO also contractually assumes responsibility for compliance with the regulations of the Equal Employment Opportunity Commission, Title VII, the National Labor Relations Act, the Fair Labor Standards Act, COBRA, ERISA, the Americans With Disabilities Act (ADA), the Family Medical & Leave Act (FMLA) and the Immigration Reform and Control Act (IRCA). Because the National Labor Relations Board views the PEO as a joint or coemployer, the PEO is required to uphold fair labor practices in regard to union organizing, collective bargaining agreements and other labor-related issues. The FMLA recognizes the PEO as the "primary" employer and confers primary compliance obligations on it. PEOs must stay abreast of all pertinent employment laws and regulations so they can provide their coemployees with compliant worksites.

The client company typically takes primary responsibility for managing employee tasks such as daily work assignments and on-site supervision; ensuring production or service delivery; and providing materials, supplies and equipment to employees.

The IRS considers the PEO to be the employer of record and, as such, liable to pay trust fund, income and unemployment taxes. (See revenue ruling 75-41, 1975 CB 323 and IRC section 3401(d)). Case law has upheld this determination even when the PEO failed to live up to its obligation to pay those taxes (*General Motors Corp. v. United States*, 91-1 USTC 50,032 (ED Mich. 1990)). However, in some states, licensing laws require the PEO to establish and maintain an employment relationship with its employees at client worksites to ensure the courts' recognition of the PEO as coemployer. A prospective PEO client should familiarize itself with its state's position on unpaid employment and unemployment taxes in a PEO relationship.

There is some variation from state to state in how workers' compensation obligations are apportioned between a PEO and its clients. Some states consider the PEO to be the responsible party. Others require multiple coordinated policies of both the client company and the PEO. Still others require PEO client companies to maintain minimum policies in

their own names. PEOs can advise prospective clients on what different states in which a client does business will require.

Congress is addressing the PEO's responsibility to its workers for employment taxes and for other employee benefits such as 401(k) and other retirement plans. The Staffing Firm Worker Benefits Act (HR 1891), sponsored by Congressman Rob Portman (R-Ohio) and cosponsored by 65 other representatives, was referred to the House Committee on Ways and Means in June 1997 but has not yet come to the House floor. HR 1891 seeks to staffing "codify the employer status of firms with respect to their workers for purposes of employment taxes and for employee benefit purposes, to clarify and enhance the ability of such firms [PEOs] to sponsor retirement and other employee benefit plans, and to facilitate the nonabusive use of such firms' services by other businesses." Under HR 1891, PEO-sponsored plans could be tested under IRS nondiscrimination rules on a disaggregated, "client- by-client" basis. In addition, the legislation would enable client companies to recognize contributions a PEO makes to its benefit plan.

REALIZING ECONOMIES OF SCALE

The obligations and administrative burdens a PEO assumes on behalf of its clients are strong incentives for small to medium-size companies to outsource these complex employee, tax, benefit and regulatory compliance areas. These advantages, however, are just part of the benefit PEO client companies realize.

Perhaps the single most attractive advantage a company gains when entering into a PEO relationship is the ability to offer employees a much wider selection of benefits—at considerably lower costs. Typically, small businesses find it difficult or impossible to offer employees multiple options in terms of health care plans, insurance (life, disability and accidental death and dismemberment), savings and investment plans (401(k) and pension plans) and other employee benefits. Due to larger employee pools, PEOs can offer employees of small to medium-size businesses the same level and quality of benefits much bigger companies provide. The results are improved employee satisfaction, better employee retention and the ability to attract high-caliber employees to smaller companies. Client companies also enjoy reduced volatility in unemployment and workers' compensation insurance rates.

THE CFO/CONTROLLER'S REWARD

Today's PEOs are a financial executive's greatest ally. As described above, PEOs assume responsibility for payroll processing; employment taxes; compliance matters and correspondence; unemployment insurance; and workers' compensation audits, areas typically handled by the CFO and his or her staff. They also assume the burden of proof—recordkeeping, documentation and explanation—in these areas. Because employment-related filings and compliance requirements are all a PEO focuses on, it can do so more efficiently than a small employer. As a client company increases in size, the efficiencies of outsourcing increase. Exposure to penalty and interest charges for late-filed or -paid payroll taxes and sanctions for technical administrative or regulatory shortcomings belongs to the PEO, not the client. In addition, a company may be able to reduce its internal administrative staffing requirements enough to compensate for the fees the PEO charges.

PEOs have professionals on staff who stay abreast of the ever-changing laws governing employer–employee relations. Their diligence in ensuring their clients' lawful workplace practices—through recordkeeping and documentation—removes the stress of monitoring the complexities of workplace regulations from small business executives who can, instead, focus on day-to-day operations and overall profitability. The time saved on non-revenue-producing activities can contribute directly to the company's bottom line.

WHY A PEO?

Why should a CPA recommend that his or her employer consider contracting with a PEO? A primary reason is to free up management resources that can be better directed at enhancing employee productivity and improving overall profitability. Cost also is a factor. According to the Department of Labor, a PEO can handle its administrative responsibilities at one-third to two-thirds of the cost an average business would incur to provide similar services. Some of the savings are achieved through staff reductions.

For one company, a manufacturer of sophisticated satellite equipment with 50 employees, the decision to outsource payroll, benefits administration and other HR functions to a PEO was driven by both cost containment objectives and the company's desire to satisfy employee needs. Engaging a PEO enabled the company to offer a better benefits package and a higher level of HR services—all at significant savings. The company also found executives had more time to focus on critical operations—time previously devoted to payroll, benefits and compliance issues. Where the company's vice-president of finance previously spent considerable time understanding employee benefits regulations, employment law and related subjects, his time is now free to focus on corporate finance issues.

PEOs also can be a blessing to companies with foreign operations. An export company with 50% Japanese ownership and a subsidiary in Japan found management was increasingly bogged down with paperwork associated with regulatory compliance matters. The company also was burdened with a problem often faced by foreign-owned businesses operating domestically. Because the company did not have very many employees in the United States, it was unable to find an attractive, competitively priced insurance and employee benefits package. Since contracting with a PEO more than three years ago, the company has realized significant benefits. The PEO enabled the company to streamline its accounting procedures, ensure regulatory compliance and obtain a level of insurance and benefits typically reserved for much larger companies. The company believes its strong benefits package helped it attract and retain the best U.S. employees. Most important, top management is free to focus on important revenue-related matters rather than being burdened with administrative tasks.

Internet Resources

www.napeo.org

The Web site of the National Association of Professional Employer Organizations, 901 North Pitt Street, Suite 150, Alexandria, Virginia 22314. The site includes a variety of resources for companies considering a PEO relationship, including industry guidelines, a directory of members by state, education opportunities, answers to commonly asked questions and the benefits of using a PEO.

www.peo.com

Calling itself the Internet connection for PEOs, this site is still under construction. It includes information on the PEO industry, a state and city guide to PEOs and links to other PEO sites.

Many PEOs have their own commercial Web sites, which list the services they offer. Some PEOs specialize in a single industry, such as

health care. A search engine directed to find “PEO” will turn up a number of companies located around the country.

SELECTING THE RIGHT PEO

To make certain companies realize the maximum benefits from PEO relationships, CPAs should help their employers find organizations that

- Can offer core services (payroll, insurance and benefits administration and regulatory compliance) as well as value-added services such as employee policies and procedures, communications and employee manuals.
- Have sound infrastructures comprising distinct departments for accounting, payroll, benefits, HR and risk management/compliance.
- Have stable financial histories and policies that promote continued fiscal integrity (annual audited financial statements and quarterly limited-scope audits to verify that all taxes are paid and required filings are made on time).
- Have experienced staff, including HR professionals and certified professional employer specialists.
- Have access to advanced computer technology and experience-rated systems to administer professional employer services.
- Have proven track records with other companies of comparable size, industry and situation, including references.
- Are members of the PEO industry’s premier organization, the National Association of Professional Employer Organizations (NAPEO), and its state chapters. Maintaining these memberships signifies that a PEO adheres to the industry’s highest standards for quality of service and professional integrity.

PAPERWORK REDUCTION

For every individual a company employs, it generates a tremendous amount of paperwork, ranging from payroll and benefit records to performance evaluations and proof of regulatory compliance. An SBA study estimated that the average small business owner spends between 7% and 25% of his or her time handling employee-related paperwork. When you add in the time spent on all the other HR tasks, this figure rises to 35% to 45%. Most small business owners recognize just how valuable a commodity their time is and would rather devote their energy to core business operations. By outsourcing these areas to a PEO, they can concentrate on making their businesses grow.

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