Understanding the PEO Arrangement

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PEO Arrangements

PEOs, (Preferred Employer Organizations) provide a wide range of services and outsourcing options for employers of all sizes. It's important for employers to know and understand the various components of the PEO relationship. The intent of this eBook is to help employers better understand various aspects of the employer-PEO relationship: (1) the overall PEO relationship (2) the business of PEOs including the contract and how they make money; and (3) the services provided by PEOs.

What is a PEO?

A PEO is an organization that may provide a variety of services to client companies ("clients") including payroll processing, tax filings, workers' compensation insurance, human resources guidance and administration, and employee benefits plans and administration. Many of the services provided by a PEO require that the client utilize the PEO's tax identification number. This means that, on day one of the PEO relationship, the client and its employees will have a new "employer of record" and will complete new W-4s, I-9s, and other new employee documentation required by the PEO. A PEO can provide many of its services because the client's employees reside on the PEO's tax identification number.

By using the PEO's tax identification number, the client may take advantage of the PEO's insurance plans, such as health insurance and workers' compensation. Consequently, the client's employees are deemed "co-employed" by both the PEO and the client. This is different than "joint employment" where both entities retain some liability. A true co-employment relationship generally means that the client remains liable for the day-to-day employment relationship and the PEO is merely a provider of administrative services. However, the definition and related liability of the co-employment relationship can vary by state and by PEO. Additionally, the services that a PEO must provide are often dictated by state statute. Generally, most states require that the PEO provide the following:

- Payroll Services
- Workers' Compensation
- State Unemployment Tax ("SUTA")

It's important to note, however, some states allow PEO client employers to "carve-out" certain programs like SUTA or workers' compensation (for example, Florida allows this). Beyond the state law requirements, many PEOs have their own internal requirements for their clients such as:

- Utilize the PEO master insurance programs including employee benefits and workers' compensation
- Include all employees of all related entities on the PEO SUTA and payroll
- Utilize the PEO Cafeteria Plan (i.e. IRS §125) for employee benefits

How do I conduct due diligence on PEOs?

There are a few ways that a prospective PEO client can conduct due diligence on a PEO.

- NAPEO: Employers can first check the National Association of PEOs (NAPEO) website to identify whether the PEO is a member of the national association. NAPEO provides significant compliance and government regulatory resources to its PEO membership to help PEOs remain aware of the vast regulatory requirements and ongoing changes. The NAPEO website also provides information to prospective PEO clients that can be very helpful with due diligence. https://www.napeo.org/what-is-a-peo/selecting-a-peo/guidelines-for-choosing-a-peo
- ESAC: The Employer Services Assurance Corporation is a private organization that provides financial and operational oversight to the PEO industry. PEOs must meet rigorous accounting, financial, and operational standards to be ESAC accredited. ESAC audits and reviews the PEOs' compliance with the ESAC standards on a regular basis. https://www.esac.org/about-esac/
- CPEO: Recently, the IRS established the Certified Professional Employer Organization (CPEO) standards. According to the IRS, "[t]o become and remain certified under the CPEO Program, CPEOs must meet tax status, background, experience, business location, financial reporting, bonding and other requirements described in the statute and regulations." https://www.irs.gov/tax-professionals/certified-professional-employer-organizations-what-you-need-to-know

Since PEOs must be licensed in any states where they have employees, many states maintain directories of PEOs licensed to operate in that state. Additionally, prospective PEO clients can check with the local Better Business Bureau and social media sites dedicated to business reviews and feedback. It's also a very good idea to ask the PEO for three references of current and previous clients.

The PEO Service Agreement

PEO service agreements come in many different shapes and sizes but there are some common elements to these contracts that are worthy of review. Most PEO contracts require client companies to demonstrate proof of commercial insurance meeting certain limits and requirements such as general liability, property, Errors & Omissions, and auto (if the client has a fleet/drivers).

Many PEO agreements impose additional fees for various services such as manual checks, off-cycle payroll runs, implementation, addition of new entities, and late funding - to name a few.

Termination Considerations. Many PEO contracts contain auto-renewal provisions that provide a limited window of opportunity to cancel the contract (usually within 30 or 60 days of the end of the term of the contract). To enforce these termination provisions, many PEO contracts contain significant early-termination fees sometimes equal to the remaining fees through the term of the agreement. In some cases, PEOs will not negotiate their termination fee provisions. However, there seems to be an increasing movement by PEOs to use a simple 30-day notice requirement.

Liability and Risk Shifting

The PEO service agreement generally contains significant liability-shifting language. For example, the PEO service agreement may shift all liability for proper employee classification under workers' compensation, Fair Labor Standards Act, and the Affordable Care Act to the client. Moreover, clients may also find themselves solely responsible for all OHSA health and safety risks and obligations. Likewise, if a government agency such as the Department of Labor wants to perform an audit or inspection, it is likely going to show up at the client's worksite and issues citations/penalties against the client.

Additionally, the service agreement generally shifts employee relations liability to the client. For example, while the client may be required to seek advice and counsel of the PEO for employee relations matters, any resulting legal claims are usually the client's liability (see Employment Practices Liability Insurance). Most PEOs take the position that the employees are merely "co-employed" which means (in its most basic terms) that the PEO generally will not accept liability for employment related litigation. Generally, PEOs take the position that they provide only administrative services and are not the day-to-day employer for employment litigation liability, which may insulate the PEO from defending on the merits. This means that if litigation ensues and the PEO is a named defendant, the PEO will likely seek dismissal of the action on the premise that the PEO is merely a co-employer providing administrative services.

Many PEOs also insulate themselves from ACA penalty exposure, even if the client company utilizes the PEO's master plan. Under the terms of the Service Agreement, the responsibility and liability for ACA penalties generally remains with the client company. The PEO may take the position that the affordability of the plan, for example, is the responsibility of the client company and not the PEO. Likewise, the PEO may claim that ensuring the offer of coverage is made to the employees is the obligation of the client company and not the PEO. PEO services with respect to ACA vary. Therefore, current and prospective clients of a PEO should ensure that the PEO is providing ACA compliance tracking and monitoring including ALE headcount tracking, measurement period tracking, employee eligibility determination, reporting, and tax form filing and distribution.

Clients should also pay close attention to employment authorizations and the Form I-9. In most cases, the client is the employer for Form I-9 purposes (Section 2) and remains liable for employee work authorization (Form I-9) compliance. While the PEO may require copies of the I-9 Forms and documents, the client company should keep all originals. In the event of an audit or inspection, the Department of Homeland Security will likely show up at the client company's place of business and not the PEO.

How do PEOs Make Money?

Most PEO consumers believe that PEOs make money through their service fees. While that is true, there are a number of additional potential revenue points inside of a PEO relationship. Understanding all the components of the PEO's fee structure will help you negotiate your agreement with the PEO.

PEO Fees

PEOs will generally charge an administrative fee for the services it provides. The fees may be structured in one of three ways: (1) Per-Employee-Per-Month (PEPM); (2) Per-Employee Per-Pay (PEPP); or (3) a percentage of payroll. PEPM/PEPP are fixed costs based on the number of employees included in each payroll submission. The PEPM/PEPP will vary with the number of employees employed and paid by the client company. The percentage of payroll fee will vary based on the total gross wages submitted by the client company each pay-period. The risk with the payroll percentage approach is that each time an employee gets a raise or a bonus – so does the PEO. Likewise, (as we discuss in the IRS Section 125/Cafeteria Plan Tax Savings section) fees based on gross wages do not provide the employer with the tax savings associated with a reduced gross taxable wage base for pretax deductions (like 401k or health insurance).

State Unemployment Tax (SUTA) and Workers' Compensation Fees

PEOs are often comprised of a number of legal entities or companies. These entities hold clients from a variety of industries. PEOs may place clients with varying SUTA and workers' compensation experience in different entities to impact at least two things: (1) the SUTA rate; and (2) workers' compensation modification factor. If a PEO does a good job of managing its client placement into its entities, it may effectively dilute the risk of the poor performers and retain an attractive SUTA rate and workers' compensation modification factor.

Because client companies sit inside of a PEO entity and utilize the PEO tax identification number, both the state unemployment taxing authority and the workers' compensation carrier establish their rates based on the PEO (not the individual client company). In turn, the PEO divides the billing among all clients and often adds in additional administrative fees that may represent revenue to the PEO. This means that the rate billed to the client company by the PEO is not necessarily the rate charged to the PEO by the carrier and/or the tax authority. This is why client companies are often charged a "SUTA fee" or "workers' compensation fee" by a PEO rather than a "tax" or "premium."

IRS Section 125/Cafeteria Plan Tax Savings

Oftentimes employers elect to utilize a cafeteria plan which allows the employer to take certain benefit deductions on a pre-tax basis. Pre-tax deductions reduce the gross taxable wage base and represent a tax savings both to the employer and the employee.

However, when working within a PEO, clients may lose their tax savings associated with the pre-tax benefits deductions. More specifically, some PEOs (certainly not all) will calculate federal tax rates based on the gross wages. However, the federal taxes charged to the PEO are based on the net-wages after qualified pre-tax Section 125 deductions. This means that the PEO retains the difference (i.e., the PEO retains the Section 125 tax savings). Clients should ask their PEO how they treat the employer Section 125 tax savings to better understand whether the client company or the PEO is realizing the tax savings.

Example: Suzy Q has a gross payroll check in the amount of $1,000. After Suzy's medical and dental deductions, her net pay is $800. The client will pay the PEO the federal tax amount due based on the $1,000 gross wages but the tax amount owed to the federal government is based on the $800 net wages. The PEO in this example retains the tax savings. It's important to note that this does not impact the employees' tax savings.

Employee Benefits Commissions

Oftentimes, client companies will take advantage of the PEO employee benefits offerings. Or, alternatively, they will allow the PEO to act as the client company's insurance broker and identify a client-sponsored employee benefits program. In either case (just like a stand-alone broker), the PEO may receive commissions on the PEO master plan and/or the client-sponsored plan placed by the PEO.

HR Product Markups (background checks, posters etc.)

Sometimes, PEOs offer additional HR products at the client's expense such as background checks, workplace posters, and job tax savings programs (i.e. the Work Opportunity Tax Credit - WOTC). PEOs often have the volume and leverage to negotiate below retail rates on various HR products. The PEO may mark-up the product to realize additional revenue. With respect to tax savings programs such as the WOTC program, the PEO may retain a percentage of the tax savings associated with the program.

PEO Services

Human Resources

One of the attractive components of a PEO is the ability to outsource the HR services to a team of experts that will help the client navigate various compliance and operational obligations. While HR services can be a very valuable aspect of the PEO service, PEO prospects should ask some important questions:

- Will the client be assigned a single HR point of contact, or will they be supported by a call center?
- What are the credentials and years of experience of the person (or team) that will be assigned to the organization?
- Will the person (or team) assigned to the client have experience with the client's industry?
- Will the PEO provide the client with a compliant handbook? If yes, is the handbook template updated regularly, and will the handbook be customized for the client's, states, culture and existing work rules?
- Will the PEO provide customized materials, employee correspondence, and policies?
- Will the PEO assume all FMLA and other leave administration? Will it provide the client with original documents or copies of documents gathered from employees? (in the event of a government audit or discovery in litigation, the client will need to have documents on hand).
- Will the PEO file the EEO1 (if required)? In 2022 the EEO1 rules changed and the EEOC is requiring PEOs to file for each client separately – will the client receive a copy of its EEO1 filing from the PEO?
- Will the PEO provide the client-company with performance management tools (i.e., performance evaluation tools, disciplinary action and coaching plan tools)?

It's also important to ensure that you have a clear understanding of the work that will remain with the client and the work that will be outsourced to the PEO. For example, will the PEO provide onsite training? Will the PEO handle investigations? Will the PEO assist with recruiting, including candidate screening and interviews? Will the PEO provide assistance with discipline and counseling?

Generally, PEOs provide "back of the house" HR administration support and the live HR work must be performed by a client-company HR professional. Additionally, some PEOs may require clients to disseminate the PEO Employee Handbook, and the handbook is often a template-based handbook that may be out of date and/or not customized for the client's industry, culture, or work-rules. Employers considering a PEO should be sure to conduct diligence with respect to the HR and compliance services offered by the PEO.

Employment Practices Liability Insurance

Included in the PEO administrative fees is (usually) coverage under the PEO's Employment Practices Liability Insurance policy (EPLI). EPLI is the insurance that responds to various causes of actions brought by employees and, in some cases, by third parties. For example, generally EPLI responds to employee claims of harassment, discrimination, and/or retaliation. EPLI is also the insurance that may respond to a guest or customer claim of harassment or a civil rights violation if the policy includes third-party coverage. Wage and hour claims (i.e. Fair Labor Standards Act - FLSA) may also be covered by EPLI, depending on the policy design.

While PEOs generally provide EPLI, the coverage is often limited as compared to an EPLI policy purchased directly by an employer. For example, most PEO EPLI policies are limited to employee claims only and exclude third-party claims along with FLSA claims. Moreover, oftentimes the PEO EPLI deductible is higher than many clients may secure on their own. For these reasons, clients in a PEO will frequently seek out their own EPLI policies to ensure they have the additional coverages important to their business. However, the integration of EPLI policies can be tricky. Most EPLI policies have a provision that requires the policy to respond "second" if there is other valid coverage. This means that the EPLI policy will require the other policy to respond first. Unfortunately, because most EPLI policies contain this provision, clients end up in the middle of an insurance carrier fight where each carrier points to the other as the primary coverage. Often, the result is the client may have to pay two deductibles before either policy will respond, which is not the ideal outcome.

In addition to insurance policy issues, coverage under the PEO EPLI will often subject the client to PEO requirements prior to taking action with employees. For example, to minimize its risk the PEO may require the client company to clear all termination decisions with its HR team. Failure to do so may result in a denial of EPLI coverage in the event of a claim.

Workers' Compensation

PEO clients generally take advantage of the PEO master workers' compensation plan. The PEO workers' compensation plan is in written under the PEO and rated by the carrier on the entirety of the PEO's covered population (all clients). The PEO often provides a workers' compensation support team to assist clients with reporting injuries, managing claims, and addressing costs. The client company generally remains responsible for properly classifying each job under the workers' compensation coding system. Likewise, it remains responsible for reporting all wages and lost time associated with workers' compensation claims. In the event of workers' compensation litigation, the PEO retains the authority and rights to work with counsel and the adjusters to determine the course of the claim.

Termination Considerations: Often if a company is in a PEO, NCCI (National Counsel of Compensation Insurance) does not promulgate an experience modification factor or rating for them. when the employer exits the PEO the broker providing the workers' compensation insurance may need to work with a third party to analyze the data and determine the employer's mod rate. In some instances, a PEO client company may have its own mod rate and in that case it is accessible through NCCI. When the client leaves the PEO arrangement, it generally will not have access to its workers' compensation claims information because it is part of the larger group comprising numerous employers.

State Unemployment Management

PEOs provide client companies with state unemployment management services. Because clients utilize the PEO tax ID number, the PEO will handle the State Unemployment Tax (SUTA) filing and payments. Likewise, the PEO will handle unemployment claims defense and appeals.

Termination Considerations: Employers should be aware that if they are with a PEO for more than three (3) years (whether multiple PEOs or one PEO), when they leave the PEO, the state will likely treat the company as a new business for SUTA purposes. However, this is usually a "win" for employers. Frequently, the PEO SUTA fee includes a mark-up that increases the cost beyond the new business rate. Additionally, in some cases the PEO may not honor the annual wage cap and the employer may pay a SUTA fee throughout the year. If an employer chooses to leave a PEO, most payroll providers will offer the same tax filing and unemployment appeal and defense services. When negotiating with the replacement payroll service, the employer should negotiate for the payroll provider to set up the employer's state unemployment accounts (this will likely require a Power of Attorney for the payroll provider).

Employee Benefits

PEOs may provide clients with the opportunity to participate in the PEO's master medical plan as well as other benefits, including dental, vision, and disability coverage among others. The rationale here is that the PEO master plan offers economies of scale – because the PEO is a "large group" plan and has significant numbers as compared to small employers, it can negotiate stronger plan designs and rate structures. However, the benefits master plans function much like workers' compensation and SUTA programs → they are all heavily dependent on overall claims performance. If the PEO master plan has a bad year, then the client company may face an increase in rates -along with everyone else in the plan – even if the client company is not the reason for the poor claims experience.

PEO master ERSIA plans (health, dental, vision etc.) are considered Multiple Employer Welfare Arrangements (MEWAs) because they are offered to many unrelated employers. This means that all PEO plans must be fully insured to avoid violating state self-funded MEWA restrictions and prohibitions.

Client companies may elect to establish their own "carve out" medical plan rather than join the master plan. Examples of when this might be a good choice include:

- The client company is already considered a "large group" on their own
- The client company has a significant employee population in a location where the master plan doesn't have a strong provider network
- The client company prefers a different carrier network to the one used by the master plan
- The client company prefers their own plan design to the one offered by the master plan

Client companies that carve out their medical plans may still participate in other PEO-offered benefits. Carve out plans will also often require their own insurance broker, which may or may not be the PEO itself.

Employee benefit plan compliance is the responsibility of the plan sponsor. Thus, for PEO-sponsored plans (including the master plan) the PEO is responsible for ensuring the plan has plan documents and Summary Plan Descriptions and also completes required annual 5500 filings. If a client company maintains its own carve out plan, it will be responsible for plan level compliance, with which the PEO may or may not be willing to assist.

Termination Considerations: Clients that participate in PEO master employee benefits plans should be aware of potential complications at the end of the PEO arrangement. If a client chooses to leave the PEO arrangement and establish its own client-sponsored employee benefit program, it generally must do so without claims data. Because PEO master plans cover many employers in one program, the PEO (usually) is unable to generate claims reports or provide claims data on a client-by-client basis. This means that when a client leaves the PEO and goes to market for its own program, the quoting carriers may (but not always) require employee health questionnaires to set the rates.

The Affordable Care Act (“ACA”)

The ACA requires employers with 50+ full-time equivalent employees to offer Minimum Essential Coverage (MEC), to 95% of its full-time employees. The coverage must also meet Minimum Value and be Affordable. The failure to offer compliant coverage can result in two different types of penalties:

A. The “A” penalty applies if the employer does not offer MEC to 95% of the full-time employees and one employee goes to the marketplace, gets a plan, and a subsidy. The “A” penalty sweeps across the entire organization because is based on the entire full-time employee population;

B. The “B” penalty applies if the employer does not offer MV/Affordable coverage and one person goes out the marketplace, gets a plan and a subsidy. The “B” penalty applies only to each individual employee that gets a plan and a subsidy (rather than the entire FTE population).

Why does this mater in a PEO environment? The ACA requires that employers file certain tax forms (generally the 1094-C and the 1095-C) to report compliance with the ACA mandate to the IRS. However, in a PEO the entity that files the ACA tax filings may vary depending on the PEO. Generally, PEOs file the ACA tax forms for all groups that utilize the PEO master health insurance plan.

However, when a client provides its own health insurance plan to its employees, known as a client sponsored plan, the PEO may or may not handle the ACA tax filings. Clients with their own plan will need to iron these details out ahead of the filing deadline. One of the ways the IRS is policing compliance is by comparing the number of W-2s filed against the 1095-Cs. If a client has its own client-sponsored plan and is filing its own ACA tax filings, it’s important that they file the tax forms under the same EIN as the W-2s (which may be the PEO tax ID) so that the IRS can recognize its compliance.

Termination Considerations. It's also important to note that when leaving a PEO, the PEO may not agree to file the 1094/1095 forms for the terminal year – even if the client company utilized the PEO and its master plan for the entire calendar year. Companies exiting a PEO must be sure to address this with the PEO and may need to identify a replacement vendor for that tax year (the replacement payroll provider likely will not provide ACA tax filing services for the time during which the employer was with PEO). Clients of PEOs should verify the ACA tax filing services with their PEO. It's also extremely important that clients retain all official documents created and/or filed by the PEO (for example, 1094-C, 1095-C, W-2s, etc.). If the client company needs copies of the tax filings after they have left the PEO, the PEO will likely impose a fee.

PEO Contracts, Taxes, Open Enrollment, and Termination of the PEO Arrangement

Tax Year and Timing

The optimal time of year to leave the PEO relationship is at the beginning of the calendar year because it is a new tax year. Moving in or out of a PEO mid-calendar year may cause a "tax reboot". This means that those taxes subject to certain limits will reset and employees may face additional tax exposure.

More specifically, the following taxes are subject to limits, and once an employee reaches that limit, the tax will subside for the remainder of the year:

- **State Unemployment Tax (SUTA) –** the SUTA rate and limits are set by each state. For example, in Florida, the minimum and maximum tax rates, effective January 1, 2022, are as follows (based on annual wages up to $7,000 per employee): Minimum rate: .0010 (.1%) or $7.00 per employee. Maximum rate: .0540 (5.4%) or $378 per employee.
- **Social Security (FICA) -** 6.2% of gross compensation up to a limit that adjusts with inflation. The taxation limit in 2022 was $147,000 of gross compensation.
- **Federal Unemployment Tax Act (FUTA) -** The FUTA tax rate is 6.0%. The tax applies to the first $7,000 you paid to each employee as wages during the year. The $7,000 is often referred to as the federal or FUTA wage base.

While leaving a PEO at the beginning of the calendar year avoids a mid-year tax restart, multiple W-2s, and multiple ACA tax forms, doing so may not be as easy as it seems. Most PEO contracts build in an administrative period prior to the services effective date. This may force a mid-year departure, which can be a significant disincentive to leave the PEO. For example, many PEO contracts may require notice of termination within 30-days prior to the effective date of the agreement, which may be at time other than the beginning of the calendar year. In some cases, a PEO may allow an employer to extend the contract on a month-to-month basis (to extend through year-end) but employers should be sure to negotiate such an extension in advance.

Example: the PEO contract effective date is October 1st (which is a reasonable time to first enter a PEO for a PEO effective date of the following January 1st). However, the contract requires 30 days advanced notice of termination prior to the effective date. Therefore, notice is due on or by August 31st and the PEO relationship would end on September 30th → midyear.

If a client must terminate the PEO relationship mid-calendar year, the best time to exit is at the beginning of a quarter. A mid-calendar-year exit may mean two W-2s and 1095-C forms, but leaving at the start of the quarter avoids loading the "quarter to date" tax accruals and simplifies the quarterly tax form 941 filing processes.

Certified PEOs and Tax Restarts

Taxes are treated differently when leaving an IRS Certified PEO ("CPEO") (see How do I conduct due diligence on PEOs?). Upon termination of the CPEO, the client company is treated as the successor employer. This means that the wages paid by the CPEO are counted in determining the client company's post CPEO federal tax obligations (not state). Therefore, employers may not face a mid-year federal tax restart when leaving a CPEO in the middle of a calendar year. You can confirm if your PEO is a CPEO by checking the IRS public listings of CPEOs.

Employee Benefits

Even if a client is able to arrange a PEO exit effective on December 31, oftentimes the exit may be mid-plan year for the PEO employee benefits plan. This means that the employer exiting the PEO relationship may hold two open enrollment periods for their employee benefits in a single 12-month period: (1) the previous PEO open enrollment; and (2) one for the client's replacement benefit program. Employees who participate in an FSA should be given ample notice so that they may -spend down any available funds. However, there is generally a 30-day period after the PEO departure that employees may continue to submit receipts – the exact time allowed will depend on specific plan language. Employees will also want to become familiar with plan language for other benefits related accounts, including Dependent Care FSAs and Transit accounts.

Oftentimes the replacement benefits plan carriers will allow plan credits. Employers should instruct their benefits broker to negotiate a deductible and out of pocket maximum credit with the replacement carriers.

Most PEOs either require or financially incentivize departing clients to take the COBRA participants with them and provide coverage through the client's new benefits programs. Some PEOs may impose an additional surcharge for the remaining COBRA participants. In other cases, the master benefits plan may not allow an employee to remain on the PEO's COBRA if the client is offering a replacement group program. Therefore, employers departing a PEO master plan program should plan on taking the COBRA participants with them to their replacement plan.

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