



What's News in Tax

Analysis that matters from Washington National Tax

Certification of Professional Employer Organizations

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Employers often outsource payroll and employment tax obligations by contracting with other companies, including IRS-certified professional employer organizations, which are allowed to make certain payments and perform payroll administration and federal employment tax reporting—tasks not necessarily available to other organizations.

Employers looking for relief from the complexity and tedium of employee payroll and employment tax withholding, deposit, and reporting obligations often engage professional employer organizations (“PEOs”).¹ A PEO, sometimes referred to as an employee leasing company, generally takes on certain responsibilities associated with payroll administration and compliance as the designated employer for those purposes in the services agreement with its customers. The extent of the PEO’s obligations, and its relationship to the individuals providing services, is typically defined in the contract between the PEO and its customer (the organization receiving the services performed by the employees).

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¹ Other multi-party arrangements involving the transfer of some of the employment tax obligations to another party include the statutory employer rules under section 3401(d)(1) or appointment of an agent under section 3504. An employer may also engage a payroll service provider although the employer remains liable for some or all of its employment tax obligations. These multi-party arrangements are generally not considered a PEO.

The term “PEO” does not carry a specific legal definition and can be used to describe a number of different unrelated organizations and arrangements with a third-party entity. With the addition of new sections 3511 and 7705,² PEOs may now apply for IRS “certification” of their status indicating that the organizations have and continue to maintain compliance with specified requirements. Treasury and the IRS recently issued final regulations relating to the requirements for PEOs opting to become and remain certified PEOs (“CPEOs”), as well as various federal employment tax and other obligations applicable to CPEOs and their customers. By the time the regulations were released, the IRS had certified 120 PEOs. A current list of CPEOs is maintained by the IRS on its website.³

Snapshot of CPEO Advantages

A CPEO can assume additional responsibilities related to payroll administration and federal employment tax reporting and payments that are not available or as certain for a non-certified PEO. Reasons for employers to select a CPEO rather than a PEO include, but are not limited to:

- Vendor Trust—certification means the organization was verified by the IRS
- Maintaining the wage base—taxes paid on a previous federal employer identification number carry over, possibly preventing double taxation
- Reduced payroll tax liability—PEO clients can be held legally responsible by the IRS for required tax deposits even if nonpayment was the PEO’s fault; CPEO clients are not held liable for unpaid federal employment taxes after remitting employees’ tax withholdings to the CPEO
- Confirmation of tax credits—federal tax credit programs (wage credits, disaster credits, etc.) are not affected when an employer partners with a CPEO.

Federal Employment Tax Obligations and Compliance

Generally, all remuneration paid to an employee by an employer is subject to federal employment taxes, consisting of taxes under the Federal Insurance Contributions Act (“FICA”), the Railroad Retirement Tax Act (“RRTA”), the Federal Unemployment Tax Act (“FUTA”), as well as federal income taxes required to be withheld on employee wages.⁴ Employment taxes include the tax liabilities of both the employee (i.e., federal income tax and the employee portion of FICA and RRTA taxes) and the employer (i.e., FUTA taxes and the employer portion of FICA and RRTA taxes). Wage base limitations apply with respect to certain employment taxes. For example, the social security portion of FICA tax is only imposed on wages up to a specified wage base (\$132,900 for 2019) for each employee from the employer in a given calendar year. If an employee moves to a new employer during the year, then the calculation of this annual limit generally starts over (i.e., the amount withheld against may exceed the

² Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

³ See 84 FR 24367, 24373 (May 28, 2019). The IRS is required by statute and regulations to make available the name and address of approved CPEOs as well as CPEOs whose certification has been suspended or revoked. Section 301.7705-2(a)(3) and (n)(4)(ii). A list of certified PEOs can be found at the following site: https://www.irs.gov/pub/irs-utl/list_of_CPEOs.pdf.

⁴ See sections 3101, 3111, 3201 et. seq., 3301, 3402.

wage base due to withholding by more than one employer).⁵ When employers are considered predecessor and successor employers, or if a merger occurs, a restart is not typically required.⁶

The employee portion of employment taxes must typically be withheld from employee wages by the employer.⁷ The withheld amounts, plus the employer share of FICA, must generally be deposited with the IRS shortly thereafter.⁸ Employers are generally liable to the IRS for the full amount of employment taxes (including the employee portions) whether or not any taxes are actually withheld.⁹ In addition, employee wages, and employment taxes that are withheld from wages, are generally required to be reported each year on a Form W-2 and on annual and quarterly employment tax documents (e.g., Forms 940 and 941).

The “employer” for this purpose, and thus the person with the employment tax obligations described above, is often the person for whom the individual employees are providing services.¹⁰ The existence of an employer-employee relationship, and the identity of the employer, is generally determined based on a consideration of the facts and circumstances and application of the various factors under a common law test.¹¹ An employer-employee relationship generally exists if the person for whom the services are rendered (or another party) has the right to direct and control the individual providing services with respect to both the result to be accomplished by the work and the details and means by which the work is accomplished.

In certain situations, someone other than the common law employer may be liable for compliance with employment tax requirements. For example, if a person or entity other than the common law employer has control over the payment of wages for the services being performed by the employees, that person is generally considered the statutory employer for federal employment tax withholding and reporting purposes.¹² An employer may also designate an agent to perform certain wage payment and employment tax responsibilities.¹³ In such a case, however, the employer and the agent remain jointly

⁵ See section 3121(a)(1); sections 31.3121(a)(1)-1(a)(3) and 31.3306(b)(1)-1(a)(3). If there is an overpayment of social security, there are procedures to recover the overpayment. See, for example, Rev. Rul. 2009-39 and Rev. Proc. 2017-28.

⁶ See sections 31.3121(a)(1)-1(b) and 31.3306(b)(1)-1(b).

⁷ Certain wage base limitations and other exceptions to this general rule apply. For example, wages paid to employees of a tax-exempt organization are generally not subject to FICA or FUTA taxes. See sections 3121(a)(16) and 3306(c)(8).

⁸ See, e.g., section 6656.

⁹ See, e.g., sections 3102(b) and 3403.

¹⁰ See sections 3401(d).

¹¹ The common law employer test has been incorporated into various provisions of the Code and regulations. See sections 3121(d)(2), 31.3121(d)-1(c), 31.3306(i)-1(a), and 31.3401(c)-1; Revenue Ruling 87-41, 1987-1 C.B. 296 (1987). For more information regarding identification of the common law employer, see [Employee or Not—Understanding and Appreciating the Common Law Test in a New Tax Paradigm](#), *What's News in Tax* (May 6, 2019).

¹² Section 3401(d)(1). Note that whether the payor has “control” over the payment of wages is generally dependent upon the facts and circumstances.

¹³ Section 3504. Taxpayers may use IRS Form 2678, *Employer/Payer Appointment of Agent*, to request approval to have an agent file returns and make deposits or payments of employment or other withholding taxes. The regulations also provide that a person will be considered designated to perform the acts required of an employer when paying wages pursuant to a “service agreement” meeting specific criteria. Section 31.3504-2.

liable with respect to the applicable employment obligations. In addition to these arrangements, an employer may enter into an agreement with a third-party PEO. Arrangements between a PEO and customer typically provide that the PEO is the employer of the customer's employees. The terms of the arrangement also often provide that the PEO is responsible for paying employees and performing all or part of the related federal tax withholding and reporting obligations. Although the PEO may be considered the statutory employer, the customer for whom the individual is providing services is often still the common law employer for federal tax purposes.¹⁴ The addition of the PEO as a co-employer does not fundamentally change the underlying relationship of the individual providing services to the customer.

Voluntary PEO Certification Program

During 2014, legislation was enacted adding new Code sections 3511 and 7705, providing for CPEOs, and establishing requirements for certification.¹⁵ These new Code sections describe the treatment of CPEOs and their obligations and liabilities, including for federal tax purposes, as well as various certification requirements. Under the legislation, the IRS was charged with establishing a voluntary certification program through which PEOs could apply for and maintain certification as a CPEO.

In May of 2016, Treasury and the IRS published (1) final and temporary regulations related to the CPEO application process and certification requirements and (2) a notice of proposed rulemaking that cross-references the temporary regulations as well as a description of the federal employment tax consequences for CPEOs and their customers.¹⁶ Additional guidance and details regarding the application procedure and certification requirements were provided in subsequent revenue procedures and notices.¹⁷ On May 23, 2019, Treasury and the IRS released final regulations taking into account the various comments received.

The new rules regarding CPEOs provide added certainty and distinction with respect to a CPEO's relationship with its customers and employees or other service providers, as well as each party's respective obligations and liabilities. These rules generally do not apply, however:

- When the CPEO and its customer are related parties (using 10 percent under section 267 and its cross-references)
- When the CPEO contract was not reported to the IRS as required
- With respect to remuneration paid to a self-employed individual in that capacity

¹⁴ Section 3401(d).

¹⁵ Stephen Beck, Jr., Achieving a Better Life Experience Act of 2014 (the "ABLE Act"), Pub. L. 113-295 (Dec. 19, 2014). The ABLE Act created sections 3511 and 7705 relating to certified PEOs and the requirements to become and remain certified.

¹⁶ See 81 FR 27315 (May 6, 2016), as corrected July 12, 2016 at 81 FR 45012; 81 FR 27360 (May 6, 2016).

¹⁷ See Revenue Procedure 2016-33 (2016-25 I.R.B. 1034); Notice 2016-49 (2016-34 I.R.B. 265); Revenue Procedure 2017-14 (2017-3-I.R.B. 426).

- With respect to any CPEO contract entered into while the CPEO's certification is suspended by the IRS, or to any CPEO whose certification has been revoked or voluntarily terminated¹⁸

Defining certain terms is helpful in understanding the application and effect of the CPEO rules, as described below:

- A *covered employee* means, with respect to any customer, an individual who performs services for the customer and is covered by a CPEO contract between the CPEO and customer.¹⁹ A self-employed individual is not a covered employee.
- A *responsible individual* means, with respect to any CPEO or CPEO applicant, any individual who:
 - Owns (directly or indirectly) 33% or more of the stock or interest, as applicable;
 - Is a director or an officer;
 - Has ultimate responsibility for –
 - Implementing decisions of the organization's governing body, regardless of title or employment status;
 - Supervising the management, administration, or operation of the organization;
 - Managing the organization's finances;
 - In the case of a partnership, the managing member or general partner; a sole proprietor; in the case of a disregarded entity, the responsible individuals of the entity above the disregard; and
 - Any other individual with primary responsibility for the organization's federal employment tax compliance.²⁰
- A *self-employed individual* means an individual with net earnings from self-employment derived from providing services covered by a CPEO contract. A self-employed individual is not a work site employee for employment tax purposes with respect to remuneration paid by a CPEO.²¹

¹⁸ See section 31.3511-1(f).

¹⁹ See section 301.7705-1(b)(5).

²⁰ See section 301.7705-1(b)(13).

²¹ See section 301.7705-1(b)(14). The preamble of the final regulations also notes that "any payment made by a CPEO to a partner in a partnership under a contract between the partnership and the CPEO must always be treated as a payment to a self-employed individual and reported as such." In other words, the use of a CPEO does not support the treatment of a partner as an employee of their partnership and "[i]t is irrelevant to the characterization of the payment whether a CPEO pays the partner or the partnership pays the partner directly." 84 F.R. 24367 at 24371. See also IRS Chief Counsel Advice 201916004 (released Apr. 19, 2019).

- A *work site* means the physical location where an individual regularly performs services for a customer of a CPEO (except that a work site cannot be the individual's residence or telework site unless the customer requires work at that location) or, if there is no such location, the location from which the customer assigns work to the individual.²²
- A *work site employee* means, with respect to a customer, a covered employee who performs services for a customer at a work site where at least 85% of the individual performing services for the customer are covered employees of the customer.²³ This determination is made on a quarterly basis.²⁴ A covered employee will be considered a work site employee for the entirety of a calendar quarter if he or she qualifies as a work site employee at any time during the quarter.²⁵
 - A self-employed individual may be treated as a covered employee solely for purposes of determining whether the 85% threshold is met.
 - Due to the challenges associated with determining work site employees, the final regulations provide a good faith determination standard. Under this standard, a CPEO's determination regarding whether a covered employee is a "work site employee" will be respected if the CPEO has made a good faith determination that the requirements have been met based on the statute, regulations, and available guidance.²⁶

Certification Requirements

A person may apply to the IRS for certification as a CPEO, or maintain previously granted certification, by providing the requisite information, demonstrating that each of the requirements have been met, and submitting to various background checks and confirmations.

Background

In evaluating suitability of a CPEO or CPEO applicant (or any of its precursor entities, related entities, or responsible individuals), the IRS may deny a request for certification or may suspend or revoke previously approved certification for:

- Failure to pay any applicable taxes or timely and accurately file any tax or information return
- Criminal offense charges, conviction, or an active investigation

²² See section 301.7705-1(b)(16).

²³ See section 301.7705-1(b)(17).

²⁴ See section 301.7705-1(b)(17)(iv).

²⁵ *Id.*

²⁶ Section 301.7705-1(b)(17)(vi).

- Sanctions, or denial, suspension or revocation of a license, registration, or accreditation for misconduct involving dishonesty, fraud, or breach of trust
- Being listed on any sanctions list compiled by the Office of Foreign Assets Control (OFAC)
- Failure to demonstrate a financial responsibility history (e.g., through credit checks)
- Failure to demonstrate adequate relevant knowledge or experience
- Participation in providing false or misleading information²⁷

In addition, a CPEO applicant must generally be a business entity or sole proprietorship (i.e., not a trust) and organized in the United States.²⁸ To the extent the CPEO is a disregarded entity or sole proprietorship, the entity must be both domestically organized and wholly owned directly by a U.S. person.²⁹

Financial Statements

A CPEO applicant must provide to the IRS a copy of its audited financial statements, related opinion and working capital statement for its most recently completed fiscal year. In addition, within six months after the end of each fiscal year, CPEOs must provide to the IRS a copy of its annual audited financial statements with an opinion of a certified public accountant (“CPA”) that the financial statements are presented fairly and in accordance with generally accepted accounting principles and, generally, a statement in the Note to the Financial Statements covered by the CPA opinion that the annual audited financial statements reflect positive working capital.³⁰

Quarterly Assertions and Attestations

CPEOs must provide a quarterly assertion signed by a responsible individual that the CPEO has withheld and deposited all applicable federal employment taxes and receive an examination level attestation from a CPA. A responsible individual generally must also sign and submit a quarterly statement verifying that the CPEO has positive working capital. These documents are generally due by the last day of the second month after the end of each calendar quarter. A CPEO applicant is generally subject to the same requirements.³¹

Bond

Each CPEO applicant is required by statute to post a bond from a qualified surety for the payment of federal employment taxes.³² The bond must be for an amount at least equal to the greater of

²⁷ Section 301.7705-2(c)(1).

²⁸ See section 301.7705-2(c)(2).

²⁹ See sections 301.7705-2(c)(2) and (d).

³⁰ See section 301.7705-2(e). Additional rules apply for newly established CPEO applicants. See section 301.7705-2(e)(ii).

³¹ See section 301.7705-2(f).

³² See sections 7705(c)(2) and 301.7705-2(g).

(1) five percent of the CPEO's section 3511 liability, up to \$1 million; or (2) \$50,000. The amount is re-determined each year, and the CPEO may be required to increase the amount of its bond to satisfy the minimum required bond amount. The applicant must satisfy the bond requirements and obtain the bond without posting collateral.³³

Reporting and Notification

CPEOs must report to the IRS upon commencement or termination of a service contract with a customer and must agree to file all federal employment tax and information returns.³⁴ Form 8973, *Certified Professional Employer Organization/Customer Reporting Agreement*, is used to report a CPEO contract and must generally be signed by both the CPEO and customer and a copy provided to the customer.³⁵ Both CPEO applicants and CPEOs must notify the IRS in the event of any change materially affecting any agreement previously made or information previously provided.³⁶

Additional rules and requirements for obtaining and retaining certification are outlined in the regulations. For example, CPEOs must use the accrual method of accounting. However, the final regulations indicate that the IRS, in future guidance, may permit alternative accounting methods.³⁷ For certain purposes, all CPEOs that are members of a controlled group are treated as a single organization.³⁸

The regulations specify that when a CPEO applicant is denied certification or withdraws its application, future guidance will set forth any detailed requirements regarding time, manner, and process by which the applicant may reapply.³⁹

Significance of Certification

Entering into an arrangement with a CPEO provides a number of advantages to a PEO's customer, including the added reassurance that these benefits are built into the structural framework of CPEO certification.

- *Vendor Trust.* PEO certification by the IRS provides both the PEO vendor as well as the employer customer with some assurance that the PEO has been vetted and verified. Baseline standards regarding the PEO's background, viability, historical tax compliance, and other important factors were sufficiently demonstrated to receive—and maintain—certified status. On

³³ See section 301.7705-2(g)(5). The regulations clarify that the surety's retention of the right to seek collateral will not, by itself, violate this requirement. Additionally, Treasury and the IRS acknowledged in the preamble of the final regulations that in certain limited circumstances posting collateral may be appropriate and an exception may be adopted in further guidance.

³⁴ See sections 3511(g) and 301.7705-2(m).

³⁵ Form 8973 is also used by CPEOs to report a service agreement described in section 31.3504-2(b)(2) with a client (i.e., designation of agent for payment of wages).

³⁶ See section 301.7705-2(k).

³⁷ See section 301.7705-2(l).

³⁸ See sections 7705(c)(4) and 301.7705-2(h).

³⁹ See section 301.7705-2(a)(2). Treasury and the IRS state that they intend to address requirements for reapplication in a future revision of Revenue Procedure 2016-33. 84 FR 24367 at 24375.

its website, the IRS makes available a list of all CPEOs who received certification as well as any CPEOs whose certification was suspended or revoked.

- *Maintaining the Wage Base.* The transition to, or away from, the use of a CPEO generally does not cause the wage base calculation to start over with respect to a work site employee. Rather, the customer is considered a predecessor employer and the CPEO a successor employer when entering into a service contract with a CPEO, with respect to a worksite employee for purposes of the annual wage base limitations.⁴⁰ The reverse is true on termination of the contract; the CPEO is considered the predecessor employer and the customer the successor employer, and thus a single wage base applies. If, however, a single employee receives remuneration pursuant to multiple CPEO contracts with different customers, the CPEO must maintain a separate annual wage base and withholding threshold for the employee with respect to each customer.⁴¹
- *Reduced Payroll Tax Liability for CPEO Customers.* CPEO customers may also generally rely on the certified status of the PEO to shift employer liability with respect to certain payroll and employment tax obligations. A CPEO is generally treated as the employer of any covered employee for federal employment tax purposes. If certain requirements are satisfied, then a CPEO is generally treated as the *exclusive* employer of any work site employee performing services for any customer of the CPEO with respect to remuneration paid by the CPEO. However, this does not affect the determination of which entity is considered the employer for other tax purposes.
- *Tax Credits.* Certain specified credits apply to the customer, not the CPEO, with respect to any work site employee performing services for the customer.⁴² As the amount of the credit is determined by reference to the amount of federal employment taxes or the amount of wages subject to federal employment taxes, the CPEO retains the information necessary to claim the credit and is required to provide the relevant information to the customer so that the customer may claim the credit. The specified credits include, for example, the work opportunity credit, employee health insurance expenses for small employees, the employer credit for paid family and medical leave, and employee retention credits with respect to disaster relief.⁴³ Treasury and the IRS are considering the application of credits in connection with wages paid to non-work site covered employees.

In addition, potential PEO clients should consider the state employment tax impact with respect to the use of PEO services, because some treatment may differ from the federal employment tax positions noted in this article.

⁴⁰ See sections 3511(b) and 31.3511-1(d).

⁴¹ See sections 301.3511-1(c) and (d).

⁴² See sections 3511(d) and 301.3511-1(e).

⁴³ See section 31.3511-1(e)(2).

Going Forward

Employers considering whether to shift their payroll and employment tax responsibilities to ease and streamline their compliance obligation have a number of different alternatives to consider. Employers should carefully consider the available options, including whether to enter into an arrangement with a CPEO, and the potential tax implications of each path.



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