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## **PEOs, CERTIFIED PEOs AND FEDERAL EMPLOYMENT TAXES - WHY THE IRS CERTIFICATION PROGRAM IS NOT ENOUGH**

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*In December 2014, after nearly 15 years of lobbying efforts by Professional Employer Organizations (PEOs), the Small Business Efficiency Act (SBEA) was enacted into law. The SBEA authorizes the Internal Revenue Service (IRS) to create a certification program for PEOs and formally incorporates the role of certified PEOs into the federal employment tax regime. Proponents of the SBEA have generally lauded the legislation as substantially beneficial to client companies as it enables client companies to rely increasingly on PEOs to support growth. This article provides (1) an introduction to the typical PEO relationship and the current law that governs federal employment tax liability and filing requirements when a client company partners with an uncertified PEO, including identifying concerns with the current law and structure, (2) a summary of the SBEA and federal employment tax liability as it applies to certified PEOs, highlighting some of the benefits of the SBEA, (3) the identification of various and perhaps troublesome issues with respect to federal employment tax liability that remain after passage of the SBEA and implementation of the IRS PEO certification program, and finally (4) an outline of four steps that could be taken, alone or in combination, to address these issues by protecting client companies that utilize PEOs from unanticipated federal employment tax liability and reducing the opportunity for tax fraud on the part of PEOs.*

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## INTRODUCTION

In December 2014, the Small Business Efficiency Act (SBEA) was enacted into law.<sup>1</sup> The SBEA provides for a voluntary IRS certification program for professional employer organizations (PEOs), codified in §§ 3511 and 7705 of the Internal Revenue Code (Code).<sup>2</sup> The statutory changes in the SBEA became effective January 1, 2016. Due to delays in implementation of the certification program, however, the Internal Revenue Service (IRS) only recently began accepting applications for PEO certification, and the first certifications were effective January 1, 2017.

Proponents of the SBEA have touted the enactment of the legislation as a huge victory, a watershed that will protect client companies, which are frequently small businesses, from unforeseen federal employment tax liability and thereby increase reliance on PEOs.<sup>3</sup> The use of PEOs would allow client companies to allocate more resources to growing their businesses, resulting in an overall benefit for the economy. According to the PEO industry, the SBEA and the related PEO certification program will strengthen legitimacy for PEOs and certainty for client companies by generally rendering a certified PEO solely liable for federal employment taxes.<sup>4</sup>

This article sets forth an analysis of the federal PEO certification program and identifies various important, and potentially hazardous,

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<sup>1</sup> Pub. L. No. 113–295, 128 Stat. 4010 (2014). The SBEA was approved by the House of Representatives as an amendment to the ABLE Act and then incorporated into the Tax Increase Prevention Act of 2014.

<sup>2</sup> All references to Sections, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended.

<sup>3</sup> See, e.g., Press Release, Prestige Employee Administrators, Inc., President Obama Signs Legislation Recognizing Certified Professional Employer Organizations in the Internal Revenue Code (Jan. 14, 2015), available at <http://www.prweb.com/releases/2015/01/prweb12437703.htm> (last visited Jan 19, 2017); Greg Slamowitz, *President Obama Signs Small Business Efficiency Act (SBEA) Into Law!*, SMALL BUS. EFFICIENCY ACT: ACCELERATING THE GROWTH OF AM.'S SMALL BUS. (Dec. 19, 2014), <http://smallbusinessefficiencyact.com/2014/12/19/president-obama-signs-small-business-efficiency-act-sbea-into-law/> (last visited Jan. 19, 2017); Greg Slamowitz, *Senator Grassley and Senator Nelson Introduce Small Business Efficiency Act (S. 479)*, SMALL BUS. EFFICIENCY ACT: ACCELERATING THE GROWTH OF AM.'S SMALL BUS. (May 13, 2015), <http://www.smallbusinessefficiencyact.com/2013/05/13/senator-grassley-and-senator-bill-nelson-introduce-small-business-efficiency-act-s-479/> (last visited Jan. 19, 2017).

<sup>4</sup> See, e.g., Press Release, NAPEO, Passage Of Legislation Providing Recognition Of PEOs In The Federal Tax Code Is Historic Moment For Industry (Dec. 16, 2014), available at <http://www.staffone.com/passage-legislation-providing-recognition-peos-federal-tax-code-historic-moment-industry/> (last visited Jan. 19, 2017); StaffingIndustry.com, *Senate Approves PEO Certification Bill; Buyers Would Get Tax Assurance* (Dec. 17, 2014), <http://www2.staffingindustry.com/-Editorial/Daily-News/-Senate-approves-PEO-certification-bill-buyers-would-get-tax-assurance-32562> (last visited Jan. 23, 2017).

issues arising from the SBEA that client companies should take into account in order to mitigate their exposure to unanticipated federal employment tax liability. Sections I and II provide an introduction to the PEO relationship and review the existing law with respect to federal employment tax liability and uncertified PEOs. This introduction includes a discussion of issues presented by the fact that many uncertified PEOs identify themselves as the employers and assume responsibility for IRS filings and payment of federal employment taxes under their own Federal Employer Identification Numbers (FEINs). In the absence of certification as a PEO under the SBEA, however, the client company generally continues to be liable for such taxes.

Sections III and IV discuss the IRS voluntary PEO certification program and federal employment tax liability as it applies to PEOs that have obtained IRS certification (CPEOs) under the SBEA. While a client company can greatly benefit from working with a CPEO, at least in terms of mitigating federal employment tax liability exposure, the discussion frames various deficiencies inherent in the SBEA legislation, giving rise to significant concerns that should be addressed to better protect client companies and combat federal employment tax fraud. These deficiencies relate to various aspects of the SBEA legislation, including: (1) the certification program is not mandatory, (2) achieving certification status, by itself, does not ensure that the CPEO will be solely liable for federal employment taxes, and (3) in the case of PEOs that determine not to seek certification, the SBEA does not address the confusion engendered by uncertified PEOs that fail to adequately disclose to their clients the federal employment tax liability that may arise, at the client level, in the course of a PEO relationship.

Finally, Section V recommends a number of steps that could be taken, alone or in combination, to address the concerns raised in this article. From a policy perspective, these additional measures would serve not only to foster growth and success among businesses that utilize PEOs, but they would also assist in reducing the tax gap through increased employment tax compliance.

## I. INTRODUCTION TO THE PEO RELATIONSHIP

PEOs, often referred to as employee leasing companies, provide comprehensive human resource (HR), benefits, tax administration, and compliance services to client companies. The client company typically outsources to the PEO many of the administrative and compliance responsibilities and the risk management associated with employment, thereby enabling the client company to focus its resources on business-related operations such as managing employee performance and output. This is a particularly attractive option for small businesses that may not have the need to hire full-time, experienced HR and legal professionals or the resources to interpret and apply the ever-changing rules and

regulations governing the employment relationship. In addition, by retaining a PEO, client companies may avail themselves of the PEO's economy of scale to obtain lower benefit costs and offer employees additional benefit options.

PEOs describe this relationship as "co-employment," whereby the PEO becomes an employer, or "co-employer" (a term of art that defies legal classification), of the employees. In such role, the PEO frequently assumes the liability associated with employment, yet the client company retains control over the employment.<sup>5</sup> In establishing a typical PEO relationship, a client company initially terminates the employment relationship with its employees. The employees are then hired by the PEO, which "leases" the employees back to the client company to perform services for the client company. In this process, employees frequently do not notice much, if any, change in their employment relationship with the client company.

PEOs often manage the employer payroll tax paperwork for client companies. In doing so, the PEO aggregates the reporting for employees of multiple client companies on a single IRS form, and files tax returns and pays all federal employment taxes using the PEO's FEIN. The PEO is listed as the employer of record for all employees without distinguishing which employees pertain to a particular client company. The FEIN of an uncertified PEO is not linked to the client company's FEIN, and, even though PEO filings often cover multiple client companies, the PEO does not allocate federal employment taxes among the respective client companies in the PEO's federal employment tax filings and payments.

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<sup>5</sup> For example, one of the largest PEOs explains its services to potential client companies as follows: "a PEO is simply a relationship in which you select a provider to become your dedicated HR management and benefits administration partner, and deliver a broad range of HR services through a 'co-employment' model. In a standard PEO, you retain the day-to-day control over how you manage your employees, and your provider handles the HR management and benefits administration . . . ." ADP Total Source website, <http://www.adp.com/solutions/services/professional-employer-organization.aspx> (last visited June 13, 2016).

Another PEO describes PEO services as follows: "As the co-employer, the PEO takes on certain, specific employer obligations, as set forth in your service agreement. This allows the PEO to handle functions such as payroll, benefits, tax remittance and related government filings. Because it acts as an employer for those purposes, the PEO can assume a greater amount of responsibility than, for example, a payroll company . . . . What's more – through this co-employment relationship with a PEO – your company can effectively and efficiently mitigate a substantial portion of the risk and responsibility associated with having employees, including risks associated with things like . . . [c]orrectly reporting, collecting and depositing taxes with state and federal authorities . . . ." Insperity, <http://www.insperity.com/blog/what-is-a-peo/> (last visited June 13, 2016).

Yet another PEO advertises: "When working with a PEO, your company enters into a shared employment relationship. The PEO becomes the 'Employer of Record' and is responsible for payroll and payroll tax compliance, benefits administration, workers' compensation, processing unemployment claims, and other HR-related administrative tasks. Your company remains the 'Worksite Employer' and continues to retain day-to-day control and direction of the worksite employees." TriNet, [http://www.trinet.com/company/news\\_and\\_press/resources/peo\\_fact.htm](http://www.trinet.com/company/news_and_press/resources/peo_fact.htm) (last visited June 13, 2016).

The service contract between the PEO and client company generally states that the PEO is liable for withholding and payment of employment taxes and may even contain a provision for the PEO to indemnify the client company for employment tax liability. The client company, on the other hand, oversees and maintains control of the day-to-day performance of the employees, including scheduling work, directing tasks, providing feedback and performance reviews, and, when necessary, making termination decisions. Future employees are recruited and interviewed by the client company but are hired by the PEO.

PEO-style relationships date back to at least the 1980s.<sup>6</sup> Over the years, driven by the ever-changing and increasingly complex employment laws and regulations, companies have been delegating more and more responsibility to PEOs for maintaining ongoing compliance and the liability associated with noncompliance. According to the National Association of Professional Employer Organizations (NAPEO),<sup>7</sup> there are between 780 and 980 PEOs operating in all 50 states.<sup>8</sup> In 2014, the PEO industry generated between \$136 and \$156 billion dollars in gross revenues.<sup>9</sup> Approximately 180,000 businesses now use PEOs to employ between 2.7 and 3.4 million workers,<sup>10</sup> and, as of 2015, up to 16 percent of small businesses were PEO clients.<sup>11</sup> Industry experts believe that there is still significant room for continued growth within the industry,<sup>12</sup> with 99 percent of PEO executives indicating that they expect an increase in worksite employees between the third quarter of 2016 and the third quarter of 2017.<sup>13</sup> In addition, client companies have experienced employment growth 9 percent higher than other small businesses and 4 percent higher than employment growth in the U.S. economy overall.<sup>14</sup> Client companies have lower employee turnover and are 50 percent less likely to go out of

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<sup>6</sup> Britton Lombardi & Yukako Ono, *Professional Employer Organizations: What Are They, Who Uses Them, and Why Should We Care?* 32 ECON. PERSP., FED. RES. BANK OF CHI., 1 (2008).

<sup>7</sup> According to NAPEO, it is the largest trade association for PEOs nationwide. NAPEO is made up of approximately 500 members from all 50 states. The organization's primary purposes are to advocate for PEO members at all levels of government and to provide education to member companies regarding the legal, regulatory, sales, marketing, and operations aspects of the PEO industry. Further details are available at [www.napeo.org](http://www.napeo.org).

<sup>8</sup> Laurie Bassi & Dan McMurrer, *An Economic Analysis: The PEO Industry Footprint*, McBassi & Company White Paper (2015).

<sup>9</sup> *Id.*

<sup>10</sup> NAPEO.org, NAPEO Industry Statistics, based on data from Bureau of Labor Statistics, <http://www.napeo.org/what-is-a-peo/about-the-peo-industry/industry-statistics> (last visited Jan. 18, 2017).

<sup>11</sup> Laurie Bassi & Dan McMurrer, *The State of the PEO Industry 2016: Markets, Value and Trends*, McBassi & Company White Paper (2016).

<sup>12</sup> *Id.*

<sup>13</sup> NAPEO.org, NAPEO Quarterly Pulse Survey – Q3 2016 Results, <http://napeo.org/docs/default-source/pulse-survey/napeo-pulse-results-q3-16.pdf?sfvrsn=2> (last visited Jan. 23, 2017).

<sup>14</sup> Laurie Bassi, & Dan McMurrer, *Professional Employer Organizations: Fueling Small Business Growth*, McBassi & Company White Paper (2013).

business than comparable companies not using a PEO.<sup>15</sup>

Along with the growth of the PEO industry, unscrupulous conduct has emerged into public view on a number of occasions.<sup>16</sup> The IRS has reported an increase in the number of tax fraud investigations resulting from PEOs failing to pay federal employment taxes, and such cases can involve substantial dollar amounts. For example, in 2015, a large PEO that covered more than 30,000 workers filed bankruptcy, listing among its debts over \$100 million in unpaid employment taxes.<sup>17</sup> The PEO's largest client company filed bankruptcy shortly thereafter, citing its inability to secure financing as a result of "potential significant tax liability" resulting from its PEO partner's unpaid employment taxes.<sup>18</sup> In 2014, the owners of a group of San Antonio-based PEOs were sentenced to prison for their role in a tax scheme that included filing fraudulent employment tax documents and failing to make employment tax payments on behalf of client companies.<sup>19</sup> According to the FBI press release, this case, which resulted in over \$130 million in losses, was "the largest real-dollar loss fraud and tax related case ever prosecuted in the Western District of Texas."<sup>20</sup> Additionally, in 2015, a Kentucky businessman who managed a PEO was sentenced to a 12-year prison term and ordered to pay more than \$108 million in restitution in part for using client employment tax-related revenues to cover personal expenses and investments in unrelated business ventures.<sup>21</sup> There are also PEOs that have simply ceased operations or filed bankruptcy without necessarily being involved in tax fraud but nevertheless leaving in their wake unpaid employment taxes. An important question in all of these cases is: which party, the client company or the PEO, is ultimately responsible for these unpaid employment taxes? The answer to this question is rarely intuitively obvious and frequently depends on a number of factors explored in Section II below.

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<sup>15</sup> Laurie Bassi & Dan McMurrer, *Professional Employer Organizations: Keeping Turnover Low and Survival High*, McBassi & Company White Paper (2014).

<sup>16</sup> Hon. David B. Torrey, *Professional Employer Organizations: Background, Issues in Workers' Compensation, and Recent Court Cases*, IAIABC Annual College, Madison, WI (May 2006).

<sup>17</sup> *In re* TS Emp't, Inc., No. 15-10243MG, 2015 Bankr. LEXIS 2747 (Bankr. S.D.N.Y. 2015).

<sup>18</sup> *In re* Corporate Res. Servs. Inc., No. 15-11546MFW (Bankr. D. Del. 2015), and related cases.

<sup>19</sup> Press Release, FBI, San Antonio Businessmen Sentenced to Federal Prison for Fraud and Tax Scheme Involving More Than \$130 Million in Real-Dollar Losses (Apr. 15, 2014), available at <https://www.fbi.gov/sanantonio/press-releases/2014/san-antonio-businessmen-sentenced-to-federal-prison-for-fraud-and-tax-scheme-involving-more-than-130-million-in-real-dollar-losses> (last visited Feb. 17, 2017).

<sup>20</sup> *Id.*

<sup>21</sup> IRS, Examples of Employment Tax Fraud Investigations - Fiscal Year 2015 (last updated Oct. 12, 2016), <https://www.irs.gov/uac/examples-of-employment-tax-fraud-investigations-fiscal-year-2015> (last visited Feb. 17, 2017).

## II. CURRENT LAW GOVERNING FEDERAL EMPLOYMENT TAX LIABILITY AND FILING REQUIREMENTS FOR UNCERTIFIED PEOs AND AREAS OF CONCERN

Despite the fact that uncertified PEOs characterize themselves, in the context of federal employment tax matters, as the employer or co-employer of employees covered by a PEO program, this characterization is often simply untrue. According to the Supreme Court, the determination of which party is the employer for federal tax purposes is not subject to any agreement or understanding between the parties,<sup>22</sup> but instead is determined by the nature of the relationship and applicable law, including the Code and the regulations promulgated thereunder. Of course, the determination of which party, the client company or the PEO, is the true employer has a significant effect on the client company's and the PEO's liability for federal employment taxes.

### A. *Common Law Employer and § 3401(d)(1) Employer Tax Liability*

Under §3401(d), the employer is responsible for withholding and remitting federal income taxes and employer- and employee-level FICA and FUTA taxes. Generally, for purposes of determining which party is the "employer" responsible for filing employment tax returns and paying federal employment taxes, the common law employer test is applied, focusing on identifying which party "has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished"<sup>23</sup> (the "Common Law Control Test"). The determination as to whether a party is, in fact, the employer under the Common Law Control Test is made irrespective of any designation of employer status made by the individual parties.<sup>24</sup> Further, the employer cannot delegate its liability for federal employment taxes to a third party.<sup>25</sup> With respect to the PEO relationship, despite the fact that PEOs often hold themselves out as the "co-employers" of the workers, the client company generally is the "employer" under the Common Law Control Test, and the PEO, in most cases, simply does not hold any right to exercise the type of

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<sup>22</sup> *See Bartels v. Birmingham*, 332 U.S. 126 (1947) ("The argument of respondents to support the administrative interpretation of the regulations is that the Government may accept the voluntary contractual arrangements of the amusement operators and entertainers to shift the tax burden from the band leaders to the operators . . . . We do not think that such a contractual shift authorizes the Commissioner to collect taxes from one not covered by the taxing statute.")

<sup>23</sup> *Prof'l and Exec. Leasing, Inc. v. Comm'r*, 89 T.C. 225, 233 (1987), *aff'd*, 862 F.2d 751 (9th Cir. 1988).

<sup>24</sup> *See Bartels v. Birmingham*, 332 U.S. 126 (1947).

<sup>25</sup> *United States v. Garami*, 184 B.R. 834, 838 (M.D. Fla. 1995) ("Because each taxpayer has a non-delegable duty to timely perform its federal [employment] tax obligations, a contract with a third party does not relieve it of its duty to do so.")

control specified under the Common Law Control Test.<sup>26</sup> The PEO relationship is structured such that it does not significantly alter the level of control the client company has over its workers prior to terminating the workers and hiring them through the PEO. Even when the PEO contract gives the PEO the concurrent right to hire and fire workers, the client company retains and exercises the right to direct and control the means and results of the employees' work as if there were no PEO involved in the relationship. Client companies use PEOs to outsource HR and related services, not to outsource control over their workers.

Section 3401(d)(1) provides an exception to the Common Law Control Test for purposes of assigning liability for federal income tax withholding.<sup>27</sup> Under § 3401(d)(1), in the event that the common law employer does not have control of the payment of wages, the party that controls such payment is deemed to be the employer for purposes of federal employment tax withholding and payment obligations, and such exception has been extended to collection of FICA and FUTA taxes as well.<sup>28</sup>

In determining who controls the payment of wages, the courts look to which party had actual legal control over the payments. Specifically, in a PEO relationship, the courts consider the timing of the payments between the client company and the PEO, as well as the payment of wages to the employees by the PEO, and the extent to which the PEO's payment of wages to the employees is contingent upon receipt of payment from the client company. If the PEO requires receipt of funds from the client company prior to issuing payments to the employees or will not issue payments to the employees absent assurance the PEO will receive payment from the client company, the PEO is merely a conduit or agent for payment and is not in control of the payment of wages for purposes of § 3401(d)(1).<sup>29</sup>

In contrast, if the PEO is responsible for the payment of wages without regard to whether it receives payment from the client company, the PEO will be considered to have control over the payment of wages. This is not a common situation among PEOs, inasmuch as most PEOs do not want to assume the liability for paying wages for employees performing services for another party absent receipt of payment from the client company or assurance that payment will be received, such as a deposit to cover the payment. However, there are situations where the

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<sup>26</sup> *Prof'l and Exec. Leasing, Inc. v. Comm'r*, 89 T.C. 225, 233 (1987), *aff'd*, 862 F.2d 751 (9th Cir. 1988); *In re Prof'l Sec. Servs., Inc.*, 162 B.R. 901, 904 (M.D. Fla. 1993); *but see In re Critical Care*, 138 B.R. 378, 382 (Bankr. E.D.N.Y.1992).

<sup>27</sup> I.R.C. § 3401(d)(1).

<sup>28</sup> *See* *Otte v. United States*, 419 U.S. 43 (1974) (holding that a person that is an employer under § 3401(d)(1), relating to income tax withholding, is also an employer for purposes of FICA withholding under § 3102; *Winstead v. United States*, 109 F.3d 989, 991 (4th Cir. 1997) (applying *Otte* to FUTA); *In re Armadillo Corp.*, 561 F.2d 1382, 1386 (10th Cir. 1977) (applying *Otte* to FUTA and to the employer's portion of FICA).

<sup>29</sup> *United States v. Garami*, 184 B.R. 834, 838 (M.D. Fla. 1995).

PEO's payment of wages to the employees is not contingent upon receipt of payment from the client company.<sup>30</sup>

It is either the common law employer, or, if one exists, the § 3401(d)(1) employer, that is liable for federal employment taxes, but not both parties. The plain language of § 3401(d) is clear, providing that the term "employer" has a different meaning when someone other than the common law employer controls the payment of wages. Under § 3401(d), "employer" no longer means the common law employer. Instead, it means the person having control of the payment of wages. Such reading is supported by the legislative history as the policy considerations reflected in § 3401(d) focus on placing liability at the precise point of control of the tax funds.<sup>31</sup> Reinforcing this approach, the IRS stated in Technical Advice Memorandum 201347020, "[i]n the event that a person other than a common law employer has control of the payment of wages, that person (the § 3401(d)(1) employer) is liable for the employer portion of the FICA tax on such wages and the common law employer is not."<sup>32</sup>

Setting aside, for the moment, the question of whether a PEO that is not the common law employer or the § 3401(d)(1) employer has the authority to file employment tax returns and pay federal employment taxes for the client company, the fact that uncertified PEOs are filing and paying federal employment taxes under their own FEINs when the PEOs are not the employers liable for such taxes is, no doubt, of significant concern to client companies. Even after the client company pays to the PEO the employees' wages, together with both the employer- and employee-level FICA and FUTA taxes, the client company could still be liable to pay the FICA and FUTA taxes to the IRS if the PEO does not properly file returns and pay the federal employment taxes.<sup>33</sup> *Client company double liability may arise even if the PEO does, in fact, file the returns and pay the federal employment taxes if the IRS is not provided with sufficient proof of payment that can be tied to a particular client company. A festering double liability potentially covering several years could be detrimental to*

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<sup>30</sup> *Id.* at 838-40.

<sup>31</sup> *See Sw. Rest. Sys., Inc. v. IRS*, 607 F.2d 1237 (9th Cir.1979) ("No one other than the person who has control of the payment of the wages is in a position to make the proper accounting and payment to the United States . . . . When it finally comes to the point of deducting from the wages earned that part which belongs to the United States and matching it with the employer's share of FICA taxes, the only person who can do that is the person who is in 'control of the payment of such wages.'") For an earlier discussion of client company liability for payroll taxes in a PEO relationship, *see* Barry L. Salkin, *Client Company Liability for Employment Taxes If a Professional Employer Organization Is Unable to Pay*, 25 J. OF TAX'N OF INVS. 31 (2008).

<sup>32</sup> TAM 201347020 (Nov. 22, 2013). For a further discussion of federal employment tax liability in a PEO relationship, *see* Elizabeth Lyon, *Certified and Uncertified PEOs Under the Small Business Efficiency Act*, 123 J. OF TAX'N 2 (2015).

<sup>33</sup> According to the IRS, "When a PEO files employment tax returns and Forms W-2 using its own name and EIN without identifying its clients or allocating wages to its clients on employment tax returns, the client will not get credit for having paid employment taxes." IRM 5.1.24.6.3 (Nov. 6, 2015).

many client companies.

At least one court has explicitly acknowledged the unfairness and potential detriment to the client company that results from the current law. In *United States v. Garami*, a federal district court overturned a lower court's decision holding that a client company was not liable for federal employment taxes where the client company already paid the appropriate amount to cover such taxes to the employee leasing company. The court instead found that the client company, as the party that controlled the workers and the payment of wages, was liable for the federal employment taxes.<sup>34</sup> In so holding, the court stated that each employer has a "non-delegable duty to timely perform its federal [employment] tax obligations" regardless of any contractual or other arrangement with a third party, and such obligation is not satisfied until payment is actually made to the government, not a third party.<sup>35</sup> Further, "unless [the government] receives information from [the uncertified PEO] breaking down [the uncertified PEO's] lump payment by individual tax identification numbers or proof that taxes have been paid for all of the employees [the uncertified PEO] leases, the government will hold the [client company] responsible for all of the taxes."<sup>36</sup> The *Garami* court recognized "the seeming unfairness of the burden this result places on a [client company] who is making a good faith attempt to comply with the law."<sup>37</sup> However, the court lacked the authority to pursue collection of the federal employment taxes from the employee leasing company where the client company was the employer liable for such taxes. The court went on to note that "as problems such as those presented in the instant case become more widespread, it is up to Congress, not the courts, to fairly and affirmatively accommodate the peculiarities of staff leasing into this country's internal revenue system."<sup>38</sup>

Currently, there is no way for the client company to ensure that an uncertified PEO is properly filing tax returns and paying federal employment taxes. As noted previously, the uncertified PEO's federal employment tax returns are not tied to the client company's FEIN, and the wages reported on the uncertified PEO's federal employment tax return are not in any way allocated to the respective client companies. Even where the client company does request and obtain a copy of the federal employment tax return from the uncertified PEO, the client company cannot confirm what portion of the information on the return represents wages paid to the client company's employees, whether the return accurately reflects aggregate wages paid by the uncertified PEO to all employees of client companies, or whether the return is a true copy of what was filed with the IRS. In fact, the IRS acknowledges that some PEOs defraud client companies by providing them with accurate

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<sup>34</sup> *United States v. Garami*, 184 B.R. 834, 838 (M.D. Fla. 1995).

<sup>35</sup> *Id.* at 838.

<sup>36</sup> *Id.* at 836.

<sup>37</sup> *Id.* at 838.

<sup>38</sup> *Id.*

employment tax information and documents, but then underreporting wages to the IRS and underpaying federal employment taxes.<sup>39</sup>

Further, because PEOs often describe the relationship as one in which the PEO is the employer or co-employer and agree to handle the responsibility of federal employment tax filings and payment in a service contract, many client companies are unaware that they could still be legally responsible to the IRS for federal employment taxes. Thus, client companies may be uninformed about the potential liabilities faced when choosing to engage with an uncertified PEO.

The lack of a link between the client company and the tax filings and payments made by the uncertified PEO also complicates IRS compliance monitoring, audit, and enforcement efforts. Because the IRS has no way of associating federal employment tax filings and payments made by an uncertified PEO under its FEIN with a particular client company, the IRS may not be able to identify when an employer has stopped paying employment taxes versus when an employer has transitioned to an uncertified PEO relationship. Enforcement efforts are further complicated where an uncertified PEO has reported and paid a portion, but not all, of the federal employment taxes due for multiple clients. How does the IRS allocate the remaining liability among client companies once the deficiency is identified?

#### B. *Section 3504 Agent Authority*

Despite the growth experienced by PEOs, prior to 2014 there were no federal tax laws or regulations specifically addressing PEOs. As a result, questions remained as to how best to address the PEO industry under existing law and whether PEOs that did not meet the definition of common law employer or § 3401(d)(1) employer even had the authority to file and pay federal employment taxes with respect to employees performing services for a client company. Further, the unfairness resulting from issues similar to those raised in *Garami*, where a client company made a good faith effort to fulfill its federal employment tax obligations through payment to a PEO yet was still liable for such taxes because the PEO did not properly file returns or pay such taxes, and the IRS lacked authority to collect from the PEO that was not the employer, continued to exist.

In 2014, the Treasury Department took a step toward regulating the role of PEOs in filing returns and paying federal employment taxes, albeit not as the "employer," by promulgation of Treasury Regulation § 31.3504-2, "Designation of payor to perform acts required of an employer" (the

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<sup>39</sup> According to the IRS, a "tactic used by third-party payers intent on defrauding clients is to provide clients with accurate employment tax returns, W-2s and W-3 while filing employment tax returns with the IRS that understate the amount of wages on which taxes are owed." IRM 5.1.24.5.2 (Aug. 15, 2012).

"2014 Dash 2 Regulations").<sup>40</sup> By way of background, § 3504 authorizes the Treasury Department to designate an agent (§ 3504 agent) that controls or pays wages on behalf of an employer to perform other acts required of the employer under the Code, including filing federal employment tax returns and paying federal employment taxes.<sup>41</sup> The § 3504 agent is jointly liable with the employer for any failure to properly withhold and pay federal employment taxes with respect to wages controlled or paid by the agent.<sup>42</sup> Pursuant to Treasury Regulation § 31.3504-1, the Treasury Department delegated authority to the IRS to designate § 3504 agents and implement terms and conditions for such agents.<sup>43</sup> Under Revenue Procedure 2013-39, in order to be designated as a § 3504 agent by the IRS, the party must first file a formal application with the IRS (Form 2678, Employer/Payer Appointment of Agent) and receive IRS approval to act as an agent of the employer for purposes of the employer's federal employment tax obligations.<sup>44</sup> However, PEOs claim to be the employers or co-employers, not agents, and thus usually do not file Form 2678 with the IRS to become authorized as a § 3504 agent approved to file and pay employment taxes on behalf of the client company under the PEO's FEIN. On the other hand, under the Code and regulations, an uncertified PEO is generally not considered to be the employer. Thus, uncertified PEOs have been, in practice, often functioning as § 3504 agents filing returns and paying employment taxes on behalf of employers without having been designated the authority, and assigned the joint liability, under § 3504.<sup>45</sup>

Recognizing this issue, the Treasury Department promulgated the 2014 Dash 2 Regulations, which provide that a PEO that asserts itself as the employer or co-employer, pays wages to the employees, and assumes responsibility for filing returns and paying employment taxes is automatically a § 3504 agent designated to file and pay federal employment taxes, including FUTA taxes.<sup>46</sup> Under the 2014 Dash 2 Regulations, the PEO is not required to file a Form 2678 or otherwise be authorized by the IRS, as is required of other § 3504 agents designated under Treasury Regulation § 31.3504-1 and Revenue Procedure 2013-39. In fact, if a PEO does file a Form 2678 and obtains IRS approval, the provisions of the 2014 Dash 2 Regulations expressly do not apply, and instead Treasury Regulation § 31.3504-1 and Revenue Procedure 2013-39

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<sup>40</sup> T.D. 9662, 2014-16 I.R.B. 933.

<sup>41</sup> I.R.C. § 3504.

<sup>42</sup> *Id.*

<sup>43</sup> T.D. 9649, 2014-2 I.R.B. 265.

<sup>44</sup> Rev. Proc. 2013-39, 2013-52 I.R.B. 830.

<sup>45</sup> *Id.*

<sup>46</sup> T.D. 9662, 2014-16 I.R.B. 933. Treasury Regulation § 31.3504-2 is not limited to PEOs; it applies to all third parties that enter a service agreement with a client company under which the third party asserts it is the employer or co-employer of the employees, pays wages or compensation to the employees for services performed for the client company, and assumes responsibility to collect, report and pay employment taxes.

apply.<sup>47</sup> Similar to other § 3504 agents, however, a PEO that is automatically authorized to act as a § 3504 agent under the 2014 Dash 2 Regulations is jointly liable for any failure to properly withhold and pay federal employment taxes with respect to any wages controlled or paid by the PEO.<sup>48</sup> The 2014 Dash 2 Regulations recognize the reality that a PEO often does not meet the definition of common law employer or the requirements of a § 3401(d)(1) employer, even though it is actively filing returns and paying federal employment taxes on behalf of client companies under the PEO's FEIN.

The 2014 Dash 2 Regulations partially address the unfairness raised in *Garami* by explicitly making PEOs liable for unpaid federal employment taxes, even if the uncertified PEO is not the employer. In fact, the IRS Internal Revenue Manual now states that “the revenue officer must pursue collection from the PEO.”<sup>49</sup> More importantly, from a policy perspective, the regulations serve the important goal of assisting the IRS in federal employment tax collection. By authorizing the PEO to file tax returns and pay federal employment taxes on behalf of the client company, and then also making the PEO jointly liable, the IRS now has an additional party to collect from when federal employment taxes are unpaid.

Notably, though, the 2014 Dash 2 Regulations do not relieve the client company from liability, thus leaving client companies such as the one in the *Garami* case still potentially exposed to liability even if the client company paid the PEO for the federal employment tax obligations. Further, agents that have filed a Form 2678 and been designated by the IRS to file federal employment taxes on behalf of the employer under Treasury Regulation § 31.3504-01 are required by Revenue Procedure 2013-39 to also file Schedule R (Form 941): Allocation Schedule for Aggregate Form 941 Filers with each federal employment tax return, allocating the proper amount of each tax payment reported on the Form 941 to the applicable employer's FEIN.<sup>50</sup> This allows the IRS to associate the wages and taxes reported and paid by the § 3504 agent with the respective employer. The allocation provision of Revenue Procedure 2013-39 expressly applies only to § 3504 agents with an approved Form 2678.<sup>51</sup> Because PEOs are not designated as § 3504 agents by the IRS and

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<sup>47</sup> *Id.*

<sup>48</sup> *Id.*; I.R.C. § 3504.

<sup>49</sup> IRM 5.1.24.6.4 (Aug. 15, 2012).

<sup>50</sup> Rev. Proc. 2013-39, § 4, 2013-52 I.R.B. 830; *see* Schedule R (Form 941): Allocation Schedule for Aggregate Form 941 Filers.

<sup>51</sup> Rev. Proc. 2013-39, § 4, 2013-52 I.R.B. 830, states as follows:

are not required to file a Form 2678, but instead are automatically designated by the Treasury Department under the 2014 Dash 2 Regulations, the allocation requirements of Revenue Procedure 2013-39 do not apply to them.<sup>52</sup> Uncertified PEOs are thus not required to link their federal employment tax filings and payments to the client company's FEIN, nor are they required to file a Schedule R with information allocating the proper amount of each federal employment tax payment to the respective client company's FEIN. Therefore, the 2014 Dash 2 Regulations fall short of addressing the issues, previously discussed herein, that result from the lack of a link between the PEO and its client companies and the allocation of tax payments to a specific client company. In fact, the regulations may have, perhaps unwittingly on the part of the IRS, complicated these issues by expressly authorizing a situation whereby federal employment tax compliance is difficult to track precisely because the client company is not associated with the uncertified PEO's tax filings and payments. Prior to the promulgation of the 2014 Dash 2 Regulations, it could have been argued that a PEO could only file returns and pay federal employment taxes under its own FEIN if it is the employer liable for such taxes, such as the common law employer, § 3401(d)(1) employer, or where the PEO filed a Form 2678, obtained IRS approval to act as a § 3504 agent, and complied with the allocation requirements of Revenue Procedure 2013-39. Instead, the 2014 Dash 2 Regulations now condone uncertified PEOs that are not the employers filing returns and paying federal employment taxes under their own FEINs without any allocation requirement.

## II. SUMMARY OF SBEA AND IRS VOLUNTARY CERTIFICATION PROGRAM AND BENEFITS TO CLIENT COMPANIES

Prior to 2017, all PEOs were uncertified PEOs. However, after nearly 15 years of efforts on the part of supporters, most prominently the NAPEO and a number of large PEOs, the passage of the SBEA in 2014 provided for a voluntary IRS certification program for PEOs and

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The agent with an approved Form 2678 is required to file one return for each tax-return period reporting the wages and employment taxes on the wages paid to its employees, and the wages and employment taxes on the wages paid by the agent to the employees of each employer for whom the agent is authorized to act ("aggregate return"). The agent's name and EIN are entered in the spaces provided for the employer on the returns, and the returns are to be executed in accordance with the form instructions. The agent must complete an allocation schedule and attach it to each aggregate return as described in the form instructions. On the allocation schedule, the agent lists the name and EIN of each employer for whom the agent is authorized to act and allocates the wages, taxes, and payments reported on the aggregate return to each employer.

<sup>52</sup> *Id.*

addressed federal employment tax liability as between the client company and CPEO. The PEO certification program is now in place, and the first PEO certifications became effective January 1, 2017. The statutory changes implemented as part of the SBEA, along with the associated Treasury regulations, impose certain certification and federal employment tax filing requirements that apply to CPEOs. These changes and requirements benefit PEOs and their client companies, as well as strengthen the IRS in its tax collection efforts.

#### *A. Federal Employment Tax Liability*

The primary statutory change implemented by the SBEA regarding PEO certification is that, pursuant to § 3511, the CPEO is solely liable for the withholding and payment of federal employment taxes with respect to employees that perform services under a service contract, provided that the contract meets certain criteria and the employees under the contract meet the definition of "work site employees."<sup>53</sup> Similar to § 3401(d)(1), this provision serves the policy goals of placing liability for federal employment taxes on the party that is responsible for the payment of wages and seeks to protect an innocent party that has no control over the failure to pay taxes from being liable for such failure.

In order for the CPEO to be liable for federal employment taxes under § 3511, the service contract between the client company and the CPEO must be in writing, and the CPEO must assume responsibility for the payment of wages, the withholding and payment of employment taxes, and the provision of employee benefits provided for in the contract "without regard to the receipt or adequacy of payment from the client company."<sup>54</sup> If the service contract does not meet these requirements, either because it is not in writing or because it does not contain each of the required provisions, the CPEO is not liable for federal employment taxes under § 3511. Instead, the federal employment tax liability would be determined in the same way it is for uncertified PEOs, i.e., using the common law employer rule, § 3401(d)(1) employer rule, and the 2014 Dash 2 Regulations.

In addition, for the CPEO to be solely liable for federal employment taxes, the employees must be "work site employees," meaning at least 85 percent of the employees at the work site must be covered by the written service contract (the "85 Percent Coverage Requirement").<sup>55</sup> If the appropriate service contract is in place but the 85 Percent Coverage Requirement is not met, the CPEO would be liable for federal employment taxes under § 3511, but the client company may be jointly liable if it is the common law employer or the § 3401(d)(1) employer.

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<sup>53</sup> I.R.C. § 3511.

<sup>54</sup> I.R.C. §§ 3511, 7705(e).

<sup>55</sup> *Id.*

The benefit of § 3511 is that the analysis of which party is liable for federal employment taxes is much clearer and more straightforward as compared to the analysis under common law or even § 3401(d)(1). There is no need to conduct an in-depth analysis of all of the facts and circumstances to determine which party has control of the various aspects of the employment relationship. Client companies can easily structure the PEO relationship to ensure the CPEO is solely liable for federal employment taxes by putting an appropriate service contract in place and meeting the 85 Percent Coverage Requirement. If the requirements of § 3511 are met, the client company is relieved of federal employment tax liability and can outsource functions to the CPEO without unanticipated risk, which is a clear benefit to client companies.

### B. *PEO Certification Requirements*

A PEO must comply with various requirements in order to acquire and maintain IRS certification. To obtain initial certification, a PEO must submit to the IRS an online application,<sup>56</sup> a copy of the PEO's most recent audited financial statements, an unmodified opinion of a CPA that the annual audited financial statements are presented fairly in accordance with GAAP, a signed assertion from the PEO that the PEO has withheld and made all required federal employment tax payments for the most recent quarter, an examination level attestation from a CPA that the assertion is fairly stated in all material respects, a signed letter from a surety confirming the surety agrees to issue a sufficient bond if the PEO obtains IRS certification,<sup>57</sup> and a \$1,000 user fee.<sup>58</sup> Once the PEO is certified, in order to maintain certification, a CPEO must obtain and maintain a bond in the requisite amount and continue to submit to the IRS quarterly assertions regarding compliance with federal employment tax obligations accompanied by examination level attestations from a CPA supporting the assertions and annual audited financial statements accompanied by an unmodified CPA opinion.<sup>59</sup>

The initial and ongoing financial review requirements for CPEOs provide some level of assurance for client companies that there will not be unpaid federal employment taxes accruing over multiple quarters or

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<sup>56</sup> The application is available at <https://services.irs.gov/datamart/-login.do;-jsessionid=IGFkRCoHUdKiLI2R3-EEB3bb> (last visited Jan. 23, 2017).

<sup>57</sup> I.R.C. § 7705(c) requires that a CPEO post a surety bond equal to the greater of (i) 5 percent of the PEO's liability for federal employment taxes under section 3511 for the immediately preceding calendar year, not to exceed \$1,000,000 or (ii) \$50,000.

<sup>58</sup> Temp. Reg. § 301.7705-2T and Rev. Proc. 2016-33, 2016-25 I.R.B. 1034, provide the current requirements for obtaining PEO certification. Notice 2016-49, 2016-34 I.R.B., provides interim guidance on the certification requirements, including relaxing a number of the certification requirements in the temporary regulations in response to comments received by the Treasury Department and the IRS.

<sup>59</sup> Temp. Reg. § 301.7705-2T and Rev. Proc. 2017-14, 2017-3 I.R.B. 426, provide the requirements for ongoing maintenance of a CPEO's certification.

years.<sup>60</sup> Of course, these requirements will not completely eliminate the existence of unscrupulous PEOs that fail to properly file returns and pay federal employment taxes, or even PEOs that experience financial difficulty or otherwise decide to cease operations leaving federal employment taxes unpaid. The requirements should, nonetheless, reduce the likelihood that a CPEO will be financially unsound, fail to pay the required federal employment taxes for extended periods of time, or commit federal employment tax fraud.

### *C. Federal Employment Tax Filing Requirements*

One important change that was implemented as part of the PEO certification program is the requirement that CPEOs include a Schedule R with their federal employment tax filings to allocate the tax payments to the FEINs of the appropriate client companies.<sup>61</sup> Such allocation on Schedule R is required for all client companies of the CPEO, not just those client companies for which the CPEO is solely liable for federal employment taxes.<sup>62</sup>

As discussed previously, a major concern of the uncertified PEO relationship is the fact that there is no way to associate the uncertified PEO's federal employment tax payments with the client company and therefore no way to verify that the uncertified PEO is properly withholding and paying federal employment taxes for the employees unless the PEO has filed a Form 2678 and been designated by the IRS as a § 3504 agent, which is uncommon among PEOs. If such federal employment taxes are not paid, or in some instances even if they are properly paid, the client company could still be liable for such taxes. With the requirement that CPEOs must allocate federal employment taxes among client companies,<sup>63</sup> client companies can review the CPEO's federal employment tax filings to verify accuracy and catch potential mistakes, negligence, or fraud. This may be especially beneficial to the client company if it works with a CPEO but not all of the requirements to shift sole liability to the CPEO have been met. In addition, Schedule R makes it possible for the IRS to better monitor and enforce compliance, benefitting all taxpayers.

### III. CONCERNS REMAINING AFTER IMPLEMENTATION OF THE SBEA AND THE PEO CERTIFICATION PROGRAM

The SBEA and the PEO certification program begin to address the major concerns with federal employment tax liability in the PEO

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<sup>60</sup> Temp. Reg. § 301.7705-2T; Rev. Proc. 2016-33, 2016-25 I.R.B. 1034; Notice 2016-49, 2016-34 I.R.B. 265; Rev. Proc. 2017-14, 2017-3 I.R.B. 426.

<sup>61</sup> Prop. Reg. § 31.3511-1(g)(3)(ii); Rev. Proc. 2017-14, 2017-3 I.R.B. 426.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

relationship, namely that the client company may remain liable for federal employment taxes when it partners with an uncertified PEO and the fact that uncertified PEOs do not allocate federal employment tax payments to the associated client company's FEIN. However, because PEO certification is voluntary and there are specific requirements that must be fulfilled in order for the CPEO to be solely liable for federal employment taxes, there will still be circumstances where, like in *Garami*, the client company remains unexpectedly liable for federal employment taxes.

#### A. *Voluntary Certification*

The first major concern with the SBEA is that the PEO certification program is entirely voluntary. A PEO is not required to obtain or maintain IRS certification, and it remains to be seen what percentage of PEOs will voluntarily obtain and maintain ongoing certification under the SBEA. Because PEOs are not required to become certified, it is likely that the issues with client companies unexpectedly remaining liable for federal employment taxes and the difficulties with monitoring uncertified PEOs' compliance with federal employment taxes filing and payments will continue, at least in some PEO relationships.

Notably, a PEO that does not qualify for certification because of financial or other reasons, or a PEO that has its certification suspended or revoked for cause,<sup>64</sup> is not precluded from continuing to operate as PEO. In addition, PEOs that engage in employment tax fraud may simply choose not to obtain certification. Likely with these types of issues in mind, the Treasury Department will make a list of CPEOs publicly available, along with a list of PEOs that have had certification suspended or revoked for failure to meet any of the ongoing certification requirements for CPEOs.<sup>65</sup> Further, a CPEO that does lose its certification, either for cause or because it simply chooses to let it lapse, will be

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<sup>64</sup> Rev. Proc. 2017-14, 2017-3 I.R.B. 426 ("The IRS may suspend and/or revoke the certification of any CPEO as a result of one or more failures to comply with any of the requirements for CPEOs described in sections 3511 and 7705 of the Code, the regulations thereunder, Rev. Proc. 2016-33, Notice 2016-49, this revenue procedure, and any other guidance issued by the IRS applicable to CPEOs . . . ." Examples of circumstances that may result in suspension and/or revocation include, but are not limited to, the CPEO's failure to submit annual audited financial statements accompanied by a CPA opinion, failure to submit the required quarterly assertion and attestation, failure to maintain a bond in the required amount, failure to submit the required Schedule R with the CPEO's federal employment tax returns, charging or conviction of the CPEO or a responsible individual of the CPEO with any criminal offense, an active IRS criminal investigation involving the CPEO or a responsible individual of the CPEO, failure to pay any taxes or file any required tax return in a timely and accurate manner. The IRS will issue a notice of suspension and proposed revocation to the CPEO, and the CPEO will have an opportunity to request review prior to revocation.)

<sup>65</sup> I.R.C. § 7705(f); Rev. Proc. 2016-33, 2016-25 I.R.B. 1034. The list of CPEOs will be published at [www.irs.gov/cpeos](http://www.irs.gov/cpeos). As of January 23, 2017, list was not yet available at this URL. Temp. Reg. § 301.7705-2T and Rev. Proc. 2017-14, 2017-3 I.R.B. 426, provide the requirements for ongoing maintenance of a CPEO's certification.

required to notify client companies of the fact that it is no longer certified, although it is unclear what the consequence will be should the PEO fail to make such notification.<sup>66</sup>

### B. *Written Services Agreement Requirements*

The second major concern with the SBEA is that even when a client company works with a CPEO, the client company may still find itself ultimately liable for federal employment taxes. A CPEO is only liable for federal employment taxes if an appropriate written service contract is in place between the client company and the CPEO. Further, to ensure the CPEO is solely liable for federal employment taxes under the SBEA, the 85 Percent Coverage Requirement must also be met. Absent a sufficient service contract and meeting the 85 Percent Coverage Requirement, simply working with a CPEO is not sufficient to transfer sole liability for federal employment taxes to the CPEO. Client companies cannot rely only on the fact that the PEOs they are working with are certified in order to determine their potential liability for unpaid federal employment taxes.

This could cause confusion among client companies, which may mistakenly believe they are protected from liability by the fact that the PEO is IRS-certified. The specter of confusion will likely be heightened by CPEO advertisements, at least some of which may fail to adequately disclose the service contract or the 85 Percent Coverage Requirement. For example, one PEO's website states: "Once certified, a PEO would take on sole liability for the collection and remission of federal employment taxes for worksite employees. Small and mid-sized businesses that contract with CPEOs would be assured that they would not be liable for employment taxes once they remit their employees' tax withholdings to the PEO."<sup>67</sup>

## IV. SUGGESTED STEPS TO ADDRESS SHORTCOMINGS OF THE SBEA

While the SBEA clearly implements a regime intended to address ambiguities inherent in PEO-client company relationships, the significant ambiguities, with attendant client company potential liability, will likely persist. While the SBEA clarifies which party is liable for federal employment taxes in a PEO relationship where the PEO is certified and provides a mechanism for client companies and the IRS to monitor compliance, certification is entirely voluntary. There are a variety of reasons that a PEO may not become certified, and a PEO that is not financially sound or that is not properly filing returns and paying federal employment taxes may simply choose not to seek certification. Uncertified PEOs will likely continue to file returns and pay federal employment taxes

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<sup>66</sup> Temp. Reg. § 301.7705-2T; Rev. Proc. 2017-14, 2017-3 I.R.B. 426.

<sup>67</sup> ARC PEO Consultants, <http://arcpeo.com/the-small-business-efficiency-act-sbea-and-its-effect-to-the-peo-industry/> (last visited June 14, 2016).

under their own FEINs even though client companies may still be liable. Despite this, there is currently no way for a client company to confirm the uncertified PEO is accurately filing returns and paying these taxes. In addition, uncertified PEOs often combine federal employment taxes for multiple client companies in one return without allocating amounts to the respective client companies, making it more difficult to monitor compliance and complicating IRS enforcement efforts. Nonetheless, there are a number of steps that federal authorities could take, alone or in combination, to address these issues.

#### A. *Require All PEOs to Become Certified*

The SBEA makes IRS certification voluntary for PEOs, and it remains to be seen what percentage of PEOs will go through the formal application process and ultimately achieve IRS certification. However, in order to benefit and protect client companies and reduce employment fraud in the PEO context, certification should be rendered mandatory for all PEOs – perhaps on a phased-in basis over a given period of time. The IRS has noted a number of relatively large PEO fraud cases in recent years,<sup>68</sup> so there is a need for some form of industry regulation. Voluntary certification likely will not be an effective tool against such fraud as unscrupulous PEOs can simply choose not to become certified. Therefore, Congress should enact follow-on legislation requiring all PEOs to eventually become certified.

Requiring every PEO to obtain IRS certification would subject all PEOs to the requirements that currently only apply to CPEOs. Subjecting each PEO to ongoing, independent financial review, including requiring the submission of annual audited financial statements and quarterly attestations of federal employment tax compliance, should limit the ability of PEOs to engage in fraudulent activity concerning the filing of returns and payment of employment taxes. Further, it would assist in identifying PEOs that are struggling financially and at risk of filing bankruptcy or otherwise ceasing operations. This would benefit client companies by reducing the amount of unpaid federal employment taxes for which they are potentially liable. In addition, the requirement to file Schedule R would assist client companies and the IRS with monitoring federal employment tax compliance. At a broader level, requiring all PEOs to be certified would serve a greater policy interest of increasing overall tax compliance and decreasing the tax gap by reducing the opportunity for tax fraud in the PEO relationship.

While many states already require PEOs to go through some level of registration or licensure, state review generally focuses on ensuring compliance with state level workers' compensation insurance and

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<sup>68</sup> See IRS, Examples of Employment Tax Fraud Investigations – Fiscal Year 2015 (last updated Oct. 12, 2016), <http://www.irs.gov/uac/examples-of-employment-tax-fraud-investigations-fiscal-year-2015> (last visited Jan. 19, 2017).

unemployment tax compliance matters, as opposed to protecting client companies or ensuring federal employment tax compliance. For example, Louisiana's registration program requires all PEOs to register with the state insurance department and the state labor department.<sup>69</sup> If a PEO wants to file state unemployment tax returns under the PEO's state EIN, registration requires posting of a \$100,000 surety bond.<sup>70</sup> If the PEO files under the client company's state EIN, however, no bonding is required.<sup>71</sup> Louisiana's registration program does not require the PEO to submit financial statements or otherwise undergo any sort of financial review. In the case of Florida, which has one of the most stringent PEO licensure programs in the country, all PEOs operating within the state are required to obtain a license and submit financial information on an annual basis.<sup>72</sup> Only large-scale PEO operators, however, are required to submit audited financial information.<sup>73</sup>

As the IRS now has its PEO certification program in place, it should not take many additional resources to implement a mandatory certification program. In addition, because the IRS's certification program addresses federal employment tax liability, all PEOs should obtain IRS certification.

#### *B. Assign Sole Liability for Federal Employment Taxes to the CPEO*

In addition to requiring all PEOs to become certified, in order to benefit and protect client companies, Congress should enact follow-on legislation assigning sole liability for *all* federal employment taxes to the CPEO with respect to the wages it distributes. Under this approach, the contractual agreement and 85 Percent Coverage Requirement would be eliminated. This would allow client companies to outsource HR and compliance matters without the risk of unanticipated liability for federal employment taxes if the CPEO fails to perform. This is especially important if a CPEO itself contributes to the confusion by claiming to be the employer of record, including paying wages under its own name, issuing W-2s under the PEO's FEIN, and filing returns and paying (or taking on responsibility for paying) federal employment taxes under the PEO's FEIN.

Currently, under § 3511, the CPEO is only solely liable for federal employment taxes if there is a sufficient service agreement in place and the 85 Percent Coverage Requirement is met.<sup>74</sup> However, it seems unlikely that client companies would be readily aware of these requirements, and,

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<sup>69</sup> LA REV. STAT. §§ 23:1761-1768.

<sup>70</sup> *Id.*; see Registration Form Professional Employer Organization State of Louisiana, available at [http://www.laworks.net/Downloads/UI/PEO\\_SuretyBond.pdf](http://www.laworks.net/Downloads/UI/PEO_SuretyBond.pdf) (last visited Jan. 23, 2017).

<sup>71</sup> *Id.*

<sup>72</sup> FLA. STAT. § 468.526(1) (2016).

<sup>73</sup> FLA. STAT. § 468.525(3)(e) (2016).

<sup>74</sup> I.R.C. § 3511.

instead, may simply believe that they are protected from liability through partnering with a PEO that has been certified by the IRS. This is of particular concern based on the fact that PEOs often already portray themselves as the employer or co-employer liable for employment-related compliance matters, including employment taxes, and the fact that PEOs may not inform the client companies of these requirements.

There is no strong argument for requiring a written services contract that includes specific terms or the 85 Percent Coverage Requirement in order to transfer sole liability for federal employment taxes to a CPEO, especially since § 3401(d)(1) transfers sole liability for such taxes without these requirements. If a PEO goes through the process of obtaining and maintaining IRS certification and the CPEO puts the employees on the CPEO's payroll, thereby holding itself out to the client company as the employer, the CPEO should be solely liable for federal employment taxes.

Further, as between the CPEO and the client company, if one party is to be solely liable for federal employment taxes, it should be the CPEO. CPEOs can protect themselves from non-payment by the client companies through requiring the companies to make deposits and including termination rights in a service agreement should a client company fail to timely make any payment to the CPEO. The CPEO is in a much better position, as compared to that of the client company, to know if, and to the extent that, federal employment tax compliance is being achieved.

*C. Implement Means for Client Company to Monitor PEO's Federal Employment Tax Compliance if Client Company Continues to Be Liable for Such Taxes*

Alternatively, if Congress is not willing to require all PEOs to become certified and to shift sole liability for federal employment taxes to all CPEOs, PEOs should be permitted to file returns for federal employment taxes under the PEO's FEIN if (i) the PEO is solely liable for such taxes (e.g., if the PEO is the § 3401(d)(1) employer) or (ii) there is a mechanism for the client company to verify that the PEO is properly filing and paying such taxes. Otherwise, the federal employment taxes should have to be filed under, or at least allocated to, the FEIN of the client company. This would benefit client companies by allowing them to monitor federal employment tax compliance and protecting them from incurring federal employment tax liabilities over extended periods of time. A straightforward way to accomplish this would be to modify the 2014 Dash 2 Regulations. Currently, even when the client company is liable for federal employment taxes, PEOs are still filing returns and paying such taxes under their own FEINs. While the PEOs claim to be the employers or co-employers, they are in fact acting as agents filing returns and paying employment taxes on behalf of the employers under § 3504. Under the 2014 Dash 2 Regulations, these PEOs are not required to comply with the

requirements imposed on other § 3504 agents, including filing a Form 2678 to obtain approval from the IRS to act as a § 3504 agent and allocating all federal employment taxes to the appropriate client company's FEIN by filing a Schedule R with each federal employment tax return. Under the 2014 Dash 2 Regulations, however, PEOs are authorized to continue filing and paying taxes on behalf of client companies without complying with the formal requirements of § 3504. By modifying the regulations to require PEOs acting as § 3504 agents to comply with the formal requirements of § 3504, a PEO that is not solely liable for federal employment taxes as the common law employer, § 3401(d)(1) employer, or a CPEO that meets the written services agreement would, in any event, be required to allocate federal employment taxes filed and paid by the PEO to the appropriate client company's FEIN. Finally, because these requirements are already in place for other § 3504 agents, Schedule R is already in use, and the IRS Electronic Federal Tax Payment System (EFTPS) system is configured to handle aggregate returns and allocation of federal employment taxes, this recommendation could be implemented in a timely manner without significant cost.

If the 2014 Dash 2 Regulations are amended as described above and a PEO does not comply with the modified regulations, the PEO would not be authorized to file returns and pay federal employment taxes under the client company's FEIN unless the PEO is liable for the federal employment taxes. This means that if the PEO is a § 3504 agent of the client company, the parties would be jointly liable for federal employment taxes. The federal employment tax filing and payment could be done under the PEO's FEIN, but it would have to be allocated to the client company's FEIN. If the PEO is not a § 3504 agent of the client company, the client company would be solely liable for federal employment taxes and such taxes would be paid under the client company's FEIN. Either way, if the PEO is not solely liable for such taxes, the filing and payment would be associated with the client company's FEIN.

Because the PEO's federal employment tax filings and payments would either be allocated to each client company's FEIN or made under the client company's FEIN, the client company would be able to verify that the amount of taxes reported and paid on behalf of employees performing services for the client company corresponds to the amount of federal employment taxes due with respect to such employment. In addition, it would be possible for client companies to easily monitor return filing and payment of federal employment taxes through use of EFTPS. The federal employment tax payments would appear under the client companies' FEINs, and the EFTPS system would allow users to view 16 months' worth of tax payment history associated with their FEINs.<sup>75</sup> This would prevent the client company from having to rely solely on information provided by the PEO in determining whether federal

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<sup>75</sup> IRS, Pub. No. 966, Electronic Federal Tax Payment System: A Guide to Getting Started (Rev. Mar. 2012).

employment taxes are being properly and timely filed and paid, and it would allow the PEO to identify any potential federal employment tax payment issues in a timely manner before the PEO potentially incurs years' worth of unpaid federal employment taxes.

Especially in situations where the client company is liable for federal employment taxes, if the government allows PEOs to file and pay federal employment taxes under the PEO's FEIN, there needs to be a user-friendly mechanism in place to enable the client company to confirm accurate filing and payment. This is necessary to protect client companies from unanticipated federal employment tax liability that could be potentially devastating, especially if the client company already paid the amount to the PEO. In fact, the IRS recommends the use of EFTPS for employers to monitor filing and payment compliance where third parties are filing and paying federal employment taxes on their behalf.<sup>76</sup> However, to date, the IRS has not provided a means for client companies to verify payments made by uncertified PEOs through EFTPS, primarily because the federal employment tax payments are not linked to the client company's FEIN.

Additionally, modifying the 2014 Dash 2 Regulations would likely reduce federal employment tax noncompliance and fraud on the part of PEOs because they would know that client companies could easily monitor filing and payment. Further, the client company has a vested interest in ensuring the federal employment taxes are properly and timely paid, and the client company has more information than the IRS in terms of the amount of wages due to the employees to confirm the accuracy of the PEO's filings and payments. Lastly, this would assist the IRS in tracking compliance and allocating liability in the event federal employment taxes are not paid.

The 2014 Dash 2 Regulations are primarily a collection tool. In order to ensure the IRS's authority to collect from a PEO that continues to file returns and pay federal employment taxes under its own FEIN but is not the employer or otherwise liable for such taxes, Congress could enact a recovery penalty similar to the trust fund recovery penalties already set forth in the Code.<sup>77</sup> A PEO-focused recovery penalty would impose liability on the PEO for a penalty in an amount equal to any unpaid federal employment taxes for which the client company paid the PEO.

#### D. *Mandate Information Disclosure*

Information disclosure is also a critical issue that should be addressed. As previously discussed, there is currently a non-trivial, and in

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<sup>76</sup> Patti Logan, *Employment Tax Collection Case*, 12 J. TAX PRAC. & PROC. 11 (2010).

<sup>77</sup> The trust fund recovery penalty is a penalty that may be assessed against a party that is responsible for collecting or paying withheld income and employment taxes and that willfully fails to collect or pay such taxes. The penalty is equal to the amount of the unpaid taxes the individual failed to withhold or pay. I.R.C. § 6672.

some cases a pervasive, lack of understanding, both on the part of client companies and even PEOs, as to the applicable law and which party is the employer for particular federal tax purposes.<sup>78</sup> This is not surprising since the law in this area is quite complex and one party may be the employer in a certain context, such as a § 3401(d)(1) employer liable for the payment of federal employment taxes, but not the employer for other tax purposes, such as certain federal tax credits.<sup>79</sup> Further, PEOs characterize their roles as employers or co-employers and advertise that a benefit of working with a PEO is that the PEO handles employment tax responsibilities. Many client companies are unaware that the determination of an entity's liability for federal employment tax purposes must be determined under the Code and applicable regulations and instead view the PEO as the employer simply because the PEO lists itself as the “Employer of Record” on payroll documents and federal employment tax returns and issues paychecks to the employees. The IRS recognizes this lack of understanding and clarity in the Internal Revenue Manual, stating that “if the contractual documents provide that the PEO assumes some or all of the employer rights and obligations, in particular with regard to payroll and applicable taxes, a client may believe it is not liable for federal employment tax obligations.”<sup>80</sup> Unfortunately, the possibility for confusion is heightened by the SBEA, which creates a situation in which a PEO can be IRS certified but still not solely liable for employment taxes.

To solve the conundrum, PEOs should be required to provide each client company with a simple, written disclosure document that warns the client company of its potential liability for federal employment taxes even if the PEO assumes responsibility for such taxes and even if the client company paid the PEO for such taxes. In addition, the disclosure should direct the client company to where they can obtain further information, such as the IRS’s website, and instruct the client company to contact its legal or tax advisor to determine the tax consequences of a particular PEO relationship.

Requiring such disclosure should reduce the incidence of client companies that mistakenly believe they have no liability for federal employment taxes, only to find out too late that they are in fact liable for such taxes despite having already paid the taxes to a PEO. At least if the client company is educated on its potential liability and the applicable law, the client company can take appropriate steps to mitigate its liability exposure. This could include filing and paying federal employment taxes under its own FEIN where appropriate, requiring the PEO to provide it with audited financial statements and/or regular attestations regarding the payment of federal employment taxes, or even structuring the relationship with greater specificity, such as requiring the PEO to control the payment

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<sup>78</sup> IRM 5.1.24.6.1 (Nov. 6, 2015).

<sup>79</sup> Elizabeth Lyon, *Federal Employment Taxes and the IRS’s PEO Certification Program*, 152 TAX NOTES 1009, 1010 (2016).

<sup>80</sup> IRM 5.1.24.6.3 (Nov. 6, 2015).

of wages such that the PEO is solely liable for federal employment taxes under § 3401(d)(1).

There is support for disclosure in the widespread use of mandatory disclosures in other areas, from the TILA-RESPA Integrated Disclosure requirements that went into effect on October 3, 2015,<sup>81</sup> to the Franchise Disclosure Documents required to be provided to prospective franchisees,<sup>82</sup> to the health warning label requirements on tobacco and alcohol products.<sup>83</sup> In fact, many industries have their own mandatory disclosure requirements. These disclosures are intended to protect consumers from unknown or unintended consequences associated with a transaction, including in situations where information provided by the other party to the transaction may confuse or mislead the consumer. A disclosure document for client companies would similarly protect client companies from unknown or unintended liability resulting from turning over federal employment tax filing and payment responsibilities to a PEO, especially in the case that the PEO holds itself out as the employer and states that it assumes full responsibility for federal employment taxes. Further, from an implementation perspective, mandatory disclosures are one of the most ubiquitous and least controversial forms of regulation.<sup>84</sup>

While the efficacy of mandatory disclosure is sometimes criticized,<sup>85</sup> in specific contexts it has been shown to be effective.<sup>86</sup> Notably, providing clear, salient information to consumers has been shown to positively affect their understanding and consumption patterns.<sup>87</sup> However, if the information disclosed is overly complex, mandatory information disclosure can have little to no effect.<sup>88</sup> Therefore, in this context, it would be important to keep the mandatory disclosure simple, direct, and to the point regarding client company liability exposure.

A disclosure document would be particularly helpful if it is combined with the recommendation to modify the 2014 Dash 2 Regulations and require that PEOs either (i) allocate federal employment tax payments to each client company's FEIN or (ii) file and pay federal employment taxes under the client company's FEIN, thereby allowing the client company to use EFTPS to verify federal employment tax payments have been timely and accurately made by the PEO. The client company

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<sup>81</sup> CFPB TILA-RESPA Integrated Disclosure Rule, 12 C.F.R. pts. 1024 and 1026 (2016).

<sup>82</sup> FTC Franchise Rule, 16 C.F.R. pts. 436 and 437 (2016).

<sup>83</sup> See, e.g., 15 U.S.C. § 1333 (cigarettes); 15 U.S.C. § 4402 (smokeless tobacco); 27 U.S.C. § 215 (alcoholic beverages).

<sup>84</sup> George Loewenstein, Cass R. Sunstein & Russell Golman, *Disclosure: Psychology Changes Everything*, 6 ANN. REV. ECON. 391 (2014).

<sup>85</sup> See, e.g., O. Ben-Shahar, & C.E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647 (2011).

<sup>86</sup> Loewenstein, Sunstein & Golman, *supra* note 84.

<sup>87</sup> Saurabh Bhargava S & Dayanand Manoli, *Psychological Frictions and Incomplete Take-up of Social Benefits: Evidence from an IRS Fields Experiment*, 105 AMER. ECON. REV. 11 (2015).

<sup>88</sup> S. Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139 (2006).

would then be alerted to its potential federal employment tax liability despite any contractual or other agreement between the parties and additionally would be informed of a means to monitor the PEO's compliance with respect to federal employment taxes for which the client company is liable.

## CONCLUSION

In conclusion, while the SBEA and the IRS's PEO certification program are important steps to address federal employment tax liability in the context of a PEO relationship, protect client companies, and reduce federal employment tax fraud, there are still a number of concerns in this area. Importantly, companies that work with uncertified PEOs, and even some client companies that work with CPEOs, may still be liable for federal employment taxes and additionally may be unaware of such potential liability. Further, an uncertified PEO will continue to file federal employment tax returns on behalf of client companies under its FEIN without allocating such federal employment taxes to the client companies, limiting the ability of client companies and the IRS to monitor the PEO's federal employment tax compliance. This article outlines a number of steps that could be taken to address these concerns, from requiring all PEOs to obtain IRS certification and shifting sole liability to all CPEOs for federal employment taxes, to mandating that PEOs properly disclose to client companies the potential liability for federal employment taxes. Implementing one or more of these steps could further protect client companies and increase federal employment tax compliance.