Professional Employer Organizations – Issues and Implications

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It is common for employers to rely on more than one source when seeking workers to address needs for changing business demands and needs for different types of expertise. Professional Employer Organizations, or PEOs, are an increasingly common resource for employers. This Issue Brief highlights several important issues businesses should consider when retaining the services of a PEO. While the paper touches on some general employee issues and wage and hour questions, its primary focus is on PEOs as they relate to and intersect with employee benefits.

Background

The PEO "Model"

PEOs have been around for a number of years. Their business model continues to evolve, and in many cases it moves much faster than the laws and regulations that impact employers. There's no clear legal definition for what constitutes a PEO, and they come in many shapes and sizes – some PEOs look a lot like traditional staffing companies, while others look more like an outsourced human resources department.

The National Association of Professional Employer Organizations (NAPEO), the leading trade organization for PEOs, describes PEOs as providing comprehensive HR solutions for small businesses. These services can include payroll, benefits, human resources functions, tax administration, and regulatory compliance assistance. As the NAPEO website says, the roles of the PEO and the client (and the identity of the employer) depend on the circumstances of each relationship, and the parties might share certain responsibilities. They may also be joint employers in some instances, and neither party is the employer for all purposes.

As is the case for PEOs, there is no legal definition for "staffing firm," though the term is used in some of the Affordable Care Act regulations. Many think of staffing firms as entities that employ workers who are "supplied" to customers of the staffing firm. Assignments might be short term, or they could last for several years.

The lack of concrete definitions, the variation in PEO models, and the overlap with a more traditional staffing firm model are why NAPEO urges business to review the terms of their "client service agreement" closely to identify each party's responsibilities. [1]

Who Is the Employer? (It Depends)

A complicated piece of the PEO puzzle is identifying the party that is the actual employer. And this is an important piece of information, because the employer is typically the entity responsible for compliance with various rules. Identifying the employer is complicated for a few reasons. First, the definition of "employer" is subject to different interpretations. Furthermore, the term "employer" is defined differently by different laws. Here are a few examples:

- Affordable Care Act (ACA) – The ACA defines employees by reference to the "common-law standard." This standard is described in more detail below, but at a high level it refers to a subjective test that looks at several factors intrinsic to the business owner/worker relationship.

- National Labor Relations Act (NLRA) – In 2016, the National Labor Relations Board adopted a new "joint employer" definition that leads to the result that more than one entity (for example, McDonald's as a franchisor and its franchisees) could be responsible as the "employer" for purposes of complying with the NLRA. The Department of Labor (DOL) reached a similar conclusion, that is, that one employee could look to more than one entity as employer for purposes of the Fair Labor Standards Act (FLSA).

- State Wage and Hour Laws – States sometimes also have different standards that apply, especially related to wage and hour laws. For example, in 2010, the California Supreme Court concluded that joint employment might exist when determining who is responsible for wages and hour rules.

PEOs and Healthcare

The ACA and the Common-Law Standard

As mentioned above, the ACA relies on the common-law standard and therefore doesn't include a "joint employer" definition. Only one entity can be the employer.

The common-law standard is quite complex and is fundamentally a facts-and-circumstances analysis. In a very general sense, the standard focuses primarily on the extent to which an employer has the right to control a worker's activities – specifically with respect to what is to be accomplished and how that work should be accomplished. The IRS has developed both a 20-factor list and a broader set of categories to help guide this analysis. However, it's important to keep in mind that no one factor will be decisive, and not all factors are equally weighted. All aspects of the relationship must be considered, and ultimately the determinative factor will be the unique nature of the relationship in question.

Luckily, the ACA contains some specific rules for sharing risk if the parties get the common-law employer analysis wrong. For instance, under the ACA, the common-law employer (again, there can be only one) is responsible for making a qualifying offer of minimum essential coverage to employees. And the common-law employer is responsible for paying the penalty if they fail to make that offer.

In light of the ACA's focus on a single employer (versus a joint employer) scenario, a properly structured PEO agreement will work even when the identity of the common-law employer is unclear. The following scenarios illustrate this eventuality in more detail:

- **PEO is the common-law employer and PEO provides health insurance.** In the easiest scenario, the PEO is viewed as the common-law employer and the PEO provides offers of MEC to the workers. In this case, the Business Owner has very little to worry about.

- **Business Owner is the common-law employer and PEO provides health insurance.** Let's say the Business Owner relies on the PEO for health insurance. At some point, the Business Owner is audited for compliance with the ACA and the IRS determines that the PEO workers are actually common-law employees of the Business Owner, causing the Business Owner to fail ACA provisions requiring offers of affordable, minimum essential coverage (MEC) to at least 95% of its full-time employees and their dependent children. Although this may pose a problem, there is some relief available if the Business Owner has taken advantage of a very important rule under the ACA. That rule gives the Business Owner credit for the offer of coverage made to the PEO workers so long as the contract between the Business Owner and the PEO provides that the payment made by the Business Owner to the PEO is higher for those workers who actually enroll in the PEO health plan.

Checklist

Below are several things for employers to consider when looking to PEOs for help with staffing needs.

1. **Who is the common-law employer?** This is a tough one to answer because the rules are very subjective. When in doubt, ask the PEO. Remember, under the common-law test, there can be only one employer. This is the most important determination for purposes of allocating employer responsibility related to employee benefit plans.

2. **Is common-law status articulated in the contract between the PEO and the client company?** If the PEO is determined to be the common-law employer, does the contract indemnify the client company from liability related to employee benefits issues?

3. **Who is responsible when there is joint employment?** For a number of laws, there can be joint employment. That means both you and the PEO may be legally liable for violations. But in most cases, one party is responsible for compliance. For example, there is joint employment liability for FMLA compliance according to a fact sheet issued by the U.S. Department of Labor in 2016. In working through the details with prospective PEOs, you will want to identify who is responsible for FMLA compliance.

4. **Is the PEO certified by the IRS?** In 2016, the IRS announced a new "Certified Professional Employer Organization" status that would allow a PEO to take on primary liability for payroll tax withholding regardless of whether the PEO is later found to be the common-law employer. This designation is quite new, but it may be a valuable safeguard for Business Owners looking to engage a PEO.

Conclusion

The PEO puzzle can be tricky. The lack of standard definitions, the various shapes and forms PEOs take, and the multitude of contractual arrangements between employers and PEOs make it impossible to develop a standard recommendation for determining where responsibility lies. Instead, employers should pay close attention to the various federal laws that apply in different situations to determine how the law views the employer/employee relationship. With respect to employee benefit plans, as well as to employer obligations under the ACA, employers should familiarize themselves with the common-law standard. In addition, employers should ensure that any PEO agreement contains provisions that will help to minimize the employer's exposure in the event that the common-law employer is misidentified. Taking the appropriate steps up front will provide the employer with some protection from potential violations and penalties that could arise in this complex area.

[1] Here's the NAPEO page on this point:
http://napeo.org/what-is-a-peo/about-the-peo-industry/what-is-co-employment