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Considerations in Cosponsoring PEO Plans

by S. Derrin Watson, APM

Professional Employer Organizations (PEOs) have been with us for many years. They can function as an outsourced human relations department. They can handle payroll, payroll taxes, employee benefits, workers compensation and other matters. Small employers can benefit by being able to provide their workers with benefit programs the employer could not otherwise provide on a cost effective basis, and avoiding the paperwork issues of employees. Large employers frequently use PEOs to reduce costs of a department (often because the PEO offers a lower level of benefits than the employer offers to its other employees).

Before 2002, there was great uncertainty about the retirement plans of PEOs. The IRS did much to clarify the operation and design of the plans with Rev. Proc. 2002-21. This Revenue Procedure allowed PEOs to establish multiple employer plans for the benefit of their worksite employees. The Procedure also made clear that if a PEO attempted to cover worksite employees under a single employer plan not cosponsored by the PEO's client organizations, the plan ran a serious risk of disqualification.

To understand this ruling and its aftermath, it is vital to understand the terminology of the ruling. A *Client Organization* (or CO) is a firm that uses the PEO to provide staffing services for some or all of its workers. It does not matter how many or how few workers the PEO provides to the CO.

A *worksite employee* is a worker that a PEO provides to a CO. At a 2003 conference, IRS officials confirmed that the true temporary employees (such as a worker who would replace a vacationing receptionist for a week) are not worksite employees. Rather, the real targets of the Rev. Proc. are workers on long-term assignment with a single employer, so called "permatemps."



Interestingly, the Rev. Proc. does not define its most important term, Professional Employer Organization. From comments of IRS officials, and the common usage of the term, a PEO is an organization which functions as an outsourced human resources department, providing staffing and payroll services for all workers at a business or department. The term is not as broad as "leasing organization," which Code §414(n) defines as an organization which provides leased employees to a recipient. A hospital that employs and

supervises staff members of local medical practices might well be a staffing organization but would not be a PEO. By contrast, a staffing firm that had the primary business of providing worksite employees would be a PEO.

For example, suppose Carla Client (a sole proprietor) decides that she wishes to focus on her business and not be bothered with payroll, reporting and benefits issues. She engages Peter's PEO to put Carla's employees on Peter's payroll. Carla has the final word on hiring and firing decisions, and bears the responsibility for training the workers and giving them supervision and assignments. However, Peter will handle all payroll functions, including tax withholding and IRS reporting, and will provide benefit plans which Carla can choose to use for her workers. In this arrangement, Carla would be the CO, and Carla's workers would be worksite employees, while Peter's PEO would be a PEO.

Several court decisions in tax matters, as well as IRS and DOL rulings, had held that specific PEOs were not the common law employers of the worksite employees on their payroll. (Whether state law treats a PEO as an employer or co-employer is irrelevant to the federal tax and ERISA status of the PEO.) Rev. Proc. 2002-21 referred to the complexity of determining whether a PEO or the CO was the common law employer of worksite employees the PEO provided for the CO.

The employee status issue is crucial for proper handling of any retirement plan a PEO establishes. If the PEO is not the common law employer of the worksite employees on its payroll, then it is a violation of the Code §401(a) exclusive benefit rule for the PEO to sponsor a qualified plan for those workers. Before Rev. Proc. 2002-21, PEOs regularly established single employer plans, arguably in violation of the exclusive benefit rule.

The Rev. Proc. said that the IRS would not raise the exclusive benefit rule with regard to the prior operation of these plans if the PEO converted them to multi-employer plans, cosponsored by some

or all of the COs using the services of the PEO's worksite employee. If a given CO did not cosponsor the plan, then the plan could not cover the CO's worksite employees. The conversion was to take place in 2004, according to a specific

timetable and operating rules the Rev. Proc. laid down.

Significantly, if a PEO plan covers one or more worksite employees of a CO which does not cosponsor the PEO's plan after the end of the 2003 plan year, the PEO cannot rely on an IRS determination letter for that plan, regardless of the date of that letter. Since that time, virtually all PEO plans have operated as multiple employer plans. The consequences of not doing so are too large to ignore.

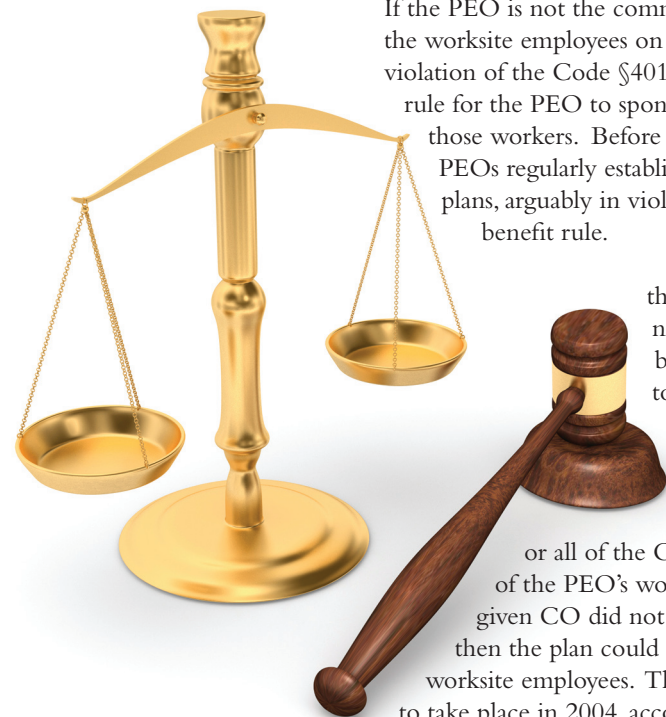
Rev. Proc. 2003-86 gave important insight and transition rules for the operation of these multiple employer plans. The key point is that the plan is to treat the worksite employees as though they are common law employees of the CO for which they provide services. Compensation the PEO pays the worksite employee is treated as though paid by the CO. (Notice that the amount the PEO pays the worker is likely different from the amount the CO pays to the PEO for the worker, since the PEO must be reimbursed for payroll taxes and overhead and will want to make a profit.)

Under Code §413(c) a multiple employer plan performs coverage and nondiscrimination testing separately for each adopting employer. To continue the earlier example, suppose Peter's PEO has 100 COs, of which 75 choose to cosponsor Peter's 401(k) plan. The plan must perform 75 separate ADP tests, one for each adopting employer (and perhaps a 76th if the plan covers Peter's back office employees or true temps). HCE status is determined at the level of the CO as well. For example, if Carla Client is on Peter's payroll, Carla would be an HCE by virtue of her ownership of her sole proprietorship, regardless of whether she has an interest in Peter's PEO.

This scenario can make it tricky for the PEO to test coverage. The PEO must know not only about the worksite employees on its payroll, but also all other common law employees of each adopting CO. Thus, if a CO uses the PEO for only some of its employees, the CO will need to provide the PEO with census information so that the PEO can properly test for coverage.

Separate testing means that adopting a PEO plan won't, in and of itself, solve an employer's ADP/ACP testing issues. The employer failing the test with a single employer plan will likely confront the same issues with the PEO plan, unless the plan has a different design.

Although a multiple employer plan tests coverage, nondiscrimination and top-heavy separately, it counts service from all adopting employers in determining eligibility and vesting. This process can lead to surprising results, which



the PEO must track carefully.

For example, suppose Ed Employee has been on Peter's payroll for two years, providing services to Carla. Before that, Ed was Carla's employee directly for another year. Ed leaves Carla and six months later, before receiving a distribution, goes to work for Barney Businessman. Barney is also a CO of Peter's PEO. On the date he is back on Peter's payroll, Barney is a rehired employee as far as the plan is concerned, and is already credited with two years of service for eligibility and vesting. The years of service Ed accrues with Barney affect the vesting of all his employer contributions in the plan, whether those contributions came from Carla or Barney.

One of the key concerns of PEO plans is the so called "bad apple" rule. A qualification defect relating to any employer cosponsoring the plan potentially subjects the entire plan to disqualification. Fortunately, compliance fees under VCP are based on the portion which is failing, rather than the plan as a whole.


For example, suppose Amalgamated Networks is a CO of Peter's PEO. Amalgamated's 30 employees participate in the PEO multiple employer retirement plan (with 5,000 other employees). Amalgamated forgets to tell Peter that Amalgamated was a part of a controlled group. As a result, Peter does not learn until 2010 that Amalgamated's portion of the plan failed coverage for 2006 through 2009. The PEO plan as a whole is subject to disqualification. Peter submits a VCP application. Under EPCRS, the compliance fee is \$1,000, based on Amalgamated's 30 participants, rather than \$20,000 based on the 5,030 participants in the plan as a whole.

Ideally, a PEO plan should include a clause requiring each adopting employer to "clean up its own backyard" to pay for the costs of correcting its mistakes. The unfortunate reality, however, is that businesses sometimes are unwilling or unable to fulfill their promises. Since the entire plan is at risk if a disqualifying defect remains uncorrected, either the PEO or the COs would need to pay for fixing a flaw of a defaulting cosponsor.

In most PEO plans, cosponsoring employers would not be plan fiduciaries. They would have no authority to exercise discretionary management or control over the plan or its assets, or to appoint, remove or supervise the trustees or other plan fiduciaries and service providers. Typically, the PEO would exercise solely, and without participation by the COs, the authority of the plan sponsor with regard to supervision and oversight.

Effectively, the only decisions that a CO cosponsor would have would relate to the amount

of discretionary contributions, and whether or not to participate in the plan (or withdraw its participation). By their very nature, these are settlor decisions and not fiduciary functions. Of course, that means that there is little a CO can do if it is dissatisfied with the administration of a PEO plan other than to withdraw from the plan. The rights of the withdrawing employer and its participating employees are governed by the terms of the plan document. Many COs have learned to their sorrow that they had limited abilities to compel distributions or transfers of the funds of their employees. A CO would do well to examine the document carefully to ensure that it can live with the arrangement throughout the lifecycle of its involvement with the plan.

PEO plans can offer adopting COs several important advantages. There are economies of scale in having a single plan to administer, update and report on. The COs and participants can enjoy the financial advantages of participating in a large trust fund. The benefits many small employers seek from PEO, simplicity for the CO and the expertise of the PEO, also makes the PEO retirement plan attractive. But the plan has some subtle costs that a prospective CO should not discount: potentially higher costs because of crediting service, the need to coordinate between the PEO plan and other plans the CO maintains (or employees on the CO's payroll), the bad apple rule and concerns over rights upon termination. The CO should also weigh carefully the stability of the PEO, because if the PEO goes out of business, the COs who were looking for simplicity may find themselves in the middle of a very complex craft moving in swift currents, with no captain at the helm. 



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