Professional Employer Organizations:

What an Employer Should Know
When Transitioning from a PEO

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Professional Employer Organizations (PEOs) were developed in order to provide a service that would allow small companies to focus on the more important task of running and growing their businesses. PEOs contract with small to midsize companies to assume and manage the responsibility of the employer. The PEO will provide an array of services to a small company, such as risk management, personnel management, human resources and payroll functions, claim management for workers compensation and unemployment insurance, and tax compliance. One of the PEO's most important functions is to provide comprehensive employee benefit packages, including group health, life, disability, and 401(k) plans.

While PEOs can provide a good employee benefits solution for a small company in the early stages of development, they will not necessarily be a cost-effective way to provide benefits once the company has grown. After crossing the 25-employee threshold, it becomes critical to consider other options for providing competitive benefit programs.

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COST ISSUES

PEOs bring a level of insurance buying power to a small employer that is otherwise unavailable to them, and can provide enhanced plan design options and cost savings for a small group. However, as a company grows beyond various underwriting thresholds to have 25, 50, or 100 employees, the odds increase that a stand–alone benefits program will be more cost effective and flexible than what the PEO can provide.

Another potential cost issue is the PEO's actual claim history. If the PEO's overall group has poor claim experience, the small employer may end up paying significantly higher premiums than it would pay on a stand-alone basis.

It is also very important to consider the financial position of the various PEOs. Most are privately held companies, and therefore it is often difficult to evaluate their financial strength. Since many PEOs self-insure certain medical and workers compensation risks, this can be a serious concern. If a PEO is bankrupt, which is not uncommon in the industry, an employer could be at risk for unfunded liabilities, even if premiums were paid to the PEO in advance.

TRANSITION ISSUES

When a company decides to terminate their arrangement with a PEO, particularly off the calendar year cycle, the employer should carefully consider the following transition issues:

- The company will assume the role of sole employer, with all attending responsibilities. For example, the company must monitor compliance with employment laws, develop policies and procedures for the workplace, assume liability for the payment of wages, and comply with all rules and regulations governing the reporting and payment of federal and state taxes.

- The company assumes the responsibility for all human resources issues, including the implementation of new benefit and retirement programs and vendors, supervising and disciplining employees, and the hiring and firing of employees.

- The Federal Insurance Contributions Act (FICA) can pose significant problems for companies considering a PEO transition during the calendar year rather than on January 1st, due to the fact that all employees become "new employees" of the company when the relationship with the PEO terminates. Currently, the social security tax rate for employers is 6.2%. This tax is subject to a dollar limit, which is adjusted annually for inflation. For 2001, the employer is obligated to withhold and to pay taxes for employees up to $80,400. Once taxes have been paid on this amount, the obligation to withhold and pay taxes for the calendar year ends. The FICA issue becomes a problem during a PEO transition because when an employee changes employers during the year, neither the employee nor the new employer receives credit for the previous withholding and payment of taxes.

- Employees who have FICA withholdings exceeding $80,400 in a calendar year due to a change in employer can obtain a refund when filing their income tax returns. While this is a considerable inconvenience, at least the refund is available.

- For employers leaving a PEO, the impact of the FICA taxes is far more problematic. The company becomes the new employer, and therefore receives no credit for any FICA taxes that were previously paid through the PEO. The company pays what can amount to significant additional taxes on employees making $80,400 or more per year. In other words, the company pays FICA taxes as much as twice. And, unlike the employee, the company does not get a refund for these additional payments. For this reason, leaving a PEO in the middle of the calendar year can be a very costly move for a company.

In conclusion, companies considering leaving a PEO should obtain professional legal and financial advice before moving forward. Depending on the circumstances, for some companies it is advisable to wait until January 1st to terminate the PEO contract, thus avoiding the FICA issue altogether.

For more information on joining, reviewing, or leaving a PEO, please contact a Benefits professional at William Gallagher Associates at (617) 261-6700.