How to Delegate Payroll, Employee-Related Tax Filings, and Associated Employer Duties to a Professional Employer Organization

By Caroline Rule and Russell A.S. Wirth

Many small- to medium-size businesses struggle with the burdensome costs of administering payroll, employee-related federal and state tax requirements, and other employee benefits. A related group of companies that finds itself in this situation may choose to establish a professional employer organization (PEO). Each of a group of related companies will become a client of the PEO, which will itself employ the small number of staff members needed to administer all these requirements of an employer for all the PEO's clients. The PEO's responsibilities may include issuing pay checks; computing and paying Social Security tax; withholding and paying federal and state income tax; withholding and paying federal and state unemployment tax and filing attendant forms; paying disability insurance tax if required under state law; providing workers' compensation insurance; and managing issues such as employees' 401(k) contributions. The PEO will charge each client for these payments together with an administrative fee. (The companies may also become individual clients of an unrelated pre-existing PEO, but it may be preferable to keep the PEO limited to the group of related companies.)

A PEO arrangement can be an extremely beneficial cost-cutting measure, but there are pitfalls (discussed below). It is advisable to consult counsel experienced in PEO-related federal and state tax controversies and state PEO law, before setting up or contracting with a PEO.

This column focuses on New York State requirements for a NYS PEO, which must register with the New York State Department of Labor (NYSDOL). As discussed below, a CPA's services may be necessary for a NYS PEO's initial registration, and thereafter are essential on a permanent ongoing basis for a NYS PEO's required quarterly financial statements.

A PEO Primer

A PEO is an entity of state law. Its key benefit is that it relieves a business of all the time and effort that it would otherwise put into payroll and employee-related tax compliance and linked issues.

The relationship between a PEO and a business is contractual, under a PEO Agreement (PEA), which can be customized based on a business's needs. State or federal law may, however, govern certain responsibilities of the PEO or client. A PEO will be designated the "administrative employer," or similar classification of its clients' employees, so it has the authority to carry out the duties of an employer, such as withholding, reporting, and paying federal and/or state unemployment tax. The PEO will report and pay taxes on a combined basis for all its clients' employees under the PEO's own federal employer identification number (FEIN).

A PEO therefore essentially becomes a co-employer. A business may be termed a "worksite employer," which retains the right to hire, fire, and discipline its worksite employees, and to direct their day-to-day work, as is necessary to carry out its business. The PEO will be deemed the employer, as provided by the PEA or federal (or state) law, in connection with some or all of the payroll and employee tax-related and employee benefits duties.

The Legal Landscape

More than two dozen states, including New York, have statutes governing PEOs, but these laws are far from uniform. PEOs are regulated by numerous different governing agencies in different states; these agencies impose different requirements for PEO registration or licensing, and different PEO responsibilities.

It is beyond the scope of this column to discuss other states' PEO rules, nor how a state-registered PEO can apply for IRS certification as a federal Certified Professional Employer Organization (CPEO). (For CPEO registration requirements, see IRC section 7705; Treasury Regulations sections 301-7705-2 et seq.; Revenue Procedure 2017-14. For defined responsibilities of a CPEO, see IRC section 3511; Treasury Regulations sections 31.3511 et seq.) A PEO's clients may be a group of related

companies, as described above, but a CPEO's clients may not be related under the provisions of IRC sections 267(b) and 707(b). Another difference is that, while a PEO's liability for unpaid federal unemployment taxes and resulting trust fund recovery penalty may vary according to the terms of the PEA and federal law, a CPEO is "solely liable" for filing returns and making deposits and payments of a client's unemployment withholding taxes, and so is also solely liable for any penalty. [See Thomson Reuters, "Federal Tax Update, Potential trust fund recovery penalty liability of different payroll service providers," Fact Sheet 2020-12 (Oct. 5, 2020).]

Ultimately, a combination of the PEA and state and federal law governs the co-employment arrangement between a PEO and its client. A PEA may either be determinative of or play into a decision whether liability for unpaid taxes or other unmet responsibilities should be imposed on the PEO, the client business, or both.

Note that for purposes of federal withholding taxes, a PEO (not a CPEO) "that pays wages or compensation [to] individual(s) performing services for any client … is designated to perform the acts required of an employer with respect to the wages or compensation paid"– and – will therefore be the responsible party if—the PEO 1) asserts that it is the employer or co-employer of a client's employees (this is required under NYS law); 2) pays wages or compensation to individual employees for services they perform for the client; and 3) assumes responsibility to collect, report and pay taxes "with respect to the [federal] wages or compensation" it pays, which may depend on the PEA [Treasury Regulations section 31.3504-2(b)]. Some PEO agreements fail the second requirement because the client makes wage payments directly from an account over which the PEO has no signatory authority; the client will then be the responsible party for federal purposes, even if it has made necessary tax payments to a defaulting PEO.

Not surprisingly, issues often arise about whether a PEO or its client is liable for unpaid taxes or unmet responsibilities; this may result in litigation. (That is also why it is wise to consult experienced tax controversy counsel before entering into a PEO arrangement.) An example of a federal issue is the IRS's determination that clients of a PEO that held itself out as a CPEO, but was not in fact registered with the IRS, were liable for employment taxes that the PEO failed to pay [see Chief Counsel Advice 2017-24025].

New York State Case Law

The first of two of the very few New York cases addressing a PEO discussed here involved a dispute between a client and its PEO. In *USA United Holdings, Inc. v. Tse-PEO, Inc.,* [23 Misc. 3d 1114(A) (Table) (Sup. Ct., Kings Cty, April 23, 2009)], the client alleged that the PEO did not pay withheld unemployment taxes to either the NYSDOL or the IRS. The court refused to dismiss claims for breach of contract, breach of fiduciary duty, and conversion. The court did not decide whether the client's breach of contract claim was barred by a "contractual limitations period" in the PEA itself, which imposed a 60-day limit from discovery for the client to assert a breach, since this issue involved factual questions such as fraudulent inducement. Because the PEO corresponded with state and federal authorities "with respect to the review and appeals of tax assessments and unemployment insurance penalties," the PEO then assumed a fiduciary role distinguishable from the PEO's tasks under the PEA. Finally, and significantly, although conversion cannot be predicated on a breach of contract, "the tax monies alleged to have been converted were not the funds of plaintiff's alone, but were actually money earned by plaintiff's employees … transferred to defendants in trust, to be paid to governmental authorities," so the client's conversion claims alleged "a separate taking or wrong" independent of breach of contract.

The second case, *In re RobsonWoese, Inc.* [42 A.D.3d 774 (3d Dept. 2007)], demonstrates that a client must be careful about entering into a PEA if it does not intend to use the PEO's services for a full calendar year. RobsonWoese terminated a PEA, under which its former employees became employees of the PEO, on June 30, 2004, and then rehired the employees.

At that time, an employer was required to make state unemployment insurance contributions based on the first $8,500 of wages for each of its employees for each year, and RobsonWoese claimed that it had made these annual contributions earlier in the year, through the PEO. The court held that although the NYS PEO statute "in a general sense, confers joint employment status on the PEO and its client," the statute "quite clearly does not do so" in connection with liabilities arising under NYS unemployment insurance law, which considers the PEO as the sole employer [see also NYS Labor Law sections 922, 923, below]. So, as of July 1, 2004, RobsonWoese "became a new employer statutorily obligated to make contributions on [its employees'] behalf for the first $8,500 in wages paid by it during the remainder of 2004."

In addition to services provided in connection with a client PEO's quarterly filings, a CPA may assist a PEO in complying with these various responsibilities under the NYS PEO statute.

The NYS PEO Statute

New York State Labor Law, Article 31, sections 915-924, the NYS PEO statute, governs a NYS PEO's registration and ongoing operations and responsibilities. All PEOs that operate in NYS must be registered with the NYSDOL.

A CPA's services may be required to register a NYS PEO. NYS Labor Law section 919—and the NYSDOL's Form LS 665 (06/20), "Professional Employer Organization Request for Registration" (available at https://on.ny.gov/2L1Tj1X), issued under the authority of section 919(8)—together detail a laundry list of registration requirements beyond the scope of this article, except that a PEO seeking registration must file an example of its PEA and a list of its clients-to-be [Labor Law section 919(1)(a)-(e); Form LS 665 E "Submission Instructions"]. In addition, a prospective PEO must attach to its registration application an audited financial statement of its most recent fiscal year, which must have been prepared within 180 days prior to submission by an independent CPA using GAAP, and must show that the PEO has a minimum net worth of $75,000 [Labor Law section 921(1); Form LS 665 E]. An independent CPA must provide a cover letter to the audited financial statement that contains additional assurances. A prospective PEO may be exempt from filing an audited financial statement, however, if it instead includes with its registration application a bond in the amount of $75,000 [Labor Law section 921(2); Form LS 665 E].

Thereafter, a PEO will need a CPA's services in order to submit its required quarterly filings to the NYSDOL. "Within 60 days of the end of each calendar quarter, the PEO must submit a statement, signed by an independent CPA, certifying that there is reasonable assurance that the firm has timely paid all applicable federal and state payroll taxes on all New York employees.... for that quarter and explaining the basis for this certification" [Form LS 665 F, "Responsibilities"; Labor Law section 921(3)]. A quarterly filing must also, *inter alia,* include the PEO's up-to-date client list.

A NYS PEO's PEA must provide that the PEO agrees to co-employ all or a majority of its client's employees; state that the PEA is intended to be ongoing rather than temporary; and detail how employer responsibilities for worksite employees, including hiring, firing, and disciplining, are allocated between the client and the PEO [Labor Law section 916(3)(a)-(c)]. Particularly important is that the PEA must state that the PEO "expressly assumes the rights and responsibilities" required under Labor Law section 922 [Labor Law section 916(3)(d)].

Under NYS Labor Law section 922, a PEA must provide that the PEO "reserves a right of direction and control over the worksite employees," although "the client shall maintain such direction and control over the worksite employees as is necessary to conduct the client's business"; and that the PEO "assumes responsibility for the withholding and remittance of payroll-related taxes and employee benefits for worksite employees and for which the professional employer organization has contractually assumed responsibility from its own accounts" [section (1)(a)(i), (ii)]. NYS Labor Law section 923, which governs a PEO's responsibility for unemployment compensation insurance, provides that a PEO is liable "for the payment of contributions, penalties and interest on wages paid ... to worksite employees," and must "report and pay all required contributions to the unemployment compensation fund" [sections (1), (2)]. *RobsonWoese, supra,* relied on sections 922 and 923 (see 42 A.D.3d at 775). A NYS PEO is also "considered an employer for purposes of withholding state income tax of worksite employees" [Labor Law section 922(2)].

In addition to services provided in connection with a client PEO's quarterly filings, a CPA may assist a PEO in complying with these various responsibilities under the NYS PEO statute. A CPA's

services may also be required for a PEO's annual re-registration, which is essentially a repeat of the original registration, including that the PEO must attach an audited financial statement to its application for re-registration, unless it opts for the bond exemption [see Labor Law sections 916(3); 921(1); Form LS 665—used both for registration and re-registration].

Advice about Handling Ongoing Registration Requirements for a NYS PEO

Although establishing and using a NYS PEO may bring significant benefits to the PEO's clients, keeping up with a NYS PEO's quarterly and yearly re-registration demands requires a significant amount of time and effort on the part of a CPA or other party who manages these filings for the PEO.

Two keys are attention to detail and planning ahead. Because various elements of quarterly filings and annual re-registrations may have to be collected from different parties (depending on who manages these filings, from a CPA, the PEO's management, or the PEO's clients), it is critical to maintain a comprehensive list of upcoming tasks and work well in advance of filing deadlines. A PEO's CPA should ask whether she should presumptively prepare quarterly financial statements in advance of each deadline.

It should be noted that the NYSDOL has some unwritten rules regarding 1) the example of a PEA that must be submitted with a PEO's application for registration (and re-registration), and 2) the PEO's client list, which must be submitted with the application for registration (thereafter quarterly, and on annual re-registration). The NYSDOL may reject these documents if they do not comply with the following "rules":

First, the PEA must include boldface numerals in the right margin next to each of these six required clauses, which must also be in boldface type: 1) the PEO expressly agrees to co-employ all or a majority of the client's employees; 2) the PEA is ongoing rather than temporary in nature (i.e., it should have a term of at least one year); 3) the PEO assumes responsibility for payroll, withholding taxes, and payroll tax payments; 4) the PEO reserves the right of direction and control over worksite employees; 5) the PEO reserves the right to hire, fire, and discipline worksite employees; and (6) although the PEO reserves the right to hire, fire, and discipline worksite employees, the client maintains direction and control over worksite employees necessary to conduct the client's business [Labor Law sections 916(3), 919(1), 922(1)(a), describing requirements of a PEA].

Second, the client list should be headed, on every page: "[Name of PEO], List of New York clients, including the name, address, FEIN, type of business, name of the New York State workers' compensation and disability insurance policyholders, and number of employees for each client as of [date on which the list will be signed]" (see Form LS 665 E). The authors have found that the list best complies with these requirements by including seven separate columns per page: Company Name, Address, FEIN, Primary Business, No. of Employees, NYS Workers' Compensation Insurance Policyholder, and NYS Disability Insurance Policyholder. (Note that the latter two columns require the policyholder, not the insurance carrier.) The policyholder for both items will likely be the PEO itself. Then, at the end of the entire list that will likely be many pages, the NYSDOL requires the total number of the PEO's clients; this could be totaled at the bottom of the "Company Name" column. The end of the list must also show the total number of employees for all clients of the PEO; this could be totaled at the bottom of the "No. of Employees" column. The list must then be signed and dated by an officer or member of the PEO, using the following language: "I, [name] [Officer or Member] of [name of PEO], certify that this list is complete, current, and accurate," and state the place where it is signed.

Although establishing and using a NYS PEO may bring significant benefits to the PEO's clients, keeping up with a NYS PEO's quarterly and yearly re-registration demands requires a significant amount of time and effort on the part of a CPA.

The NYSDOL now accepts PEO-related submissions either by mail or email. (Before making an email submission to PEOinfo.LS@labor.ny.gov, it is advisable to ensure that the NYSDOL will still accept it; it is usually prompt in replying to email queries.)

Operating a PEO becomes less demanding over time. Once a PEO's CPA has become accustomed to proactively preparing statements for the PEO's quarterly submissions, as well as the annual submissions (if required), this role can become routine, as well as a consistent source of business. ■

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