Department of Revenue Washington State

Excise Tax Advisory

Excise Tax Advisories are interpretive statements authorized by RCW 34.05.230.

ETA 3192.2014 Issue Date: October 9, 2014

Professional Employer Organizations

Purpose

This Excise Tax Advisory (ETA) clarifies when a professional employer organization (PEO) providing employer services is eligible for a business and occupation (B&O) tax deduction from gross income for qualifying costs paid to or on behalf of covered employees under RCW 82.04.540.

This ETA includes a number of examples under specific sets of facts. The examples provided are not exhaustive and should be used only as a general guide. The tax results of other situations must be determined separately after a review of all of the facts and circumstances.

Definitions

Professional employer organization means a person engaged in the business of providing professional employer services.

Professional employer services means the service of entering into a coemployment relationship with a client, in which all or a majority of the employees providing services to a client or to a division or work unit of a client are covered employees.

Client means any person who enters into a professional employer agreement with a professional employer organization.

Covered Employee means an individual, having a coemployment relationship with a professional employer organization and a client, who meets the following criteria: (1) the individual has received written notice of coemployment with the professional employer organization and (2) the individual's coemployment relationship is pursuant to a professional employer agreement. This issue is discussed more fully in the requirements section below.

Qualifying costs are the actual costs of wages and salaries, benefits, workers' compensation, payroll taxes, withholding, or other assessments paid to or on behalf of a covered employee by the PEO under a professional employer agreement.

PEO Requirements

A PEO, whether providing services to the public or to one or more affiliates, is allowed a B&O deduction equal to the portion of the fee charged to the client that represents the qualifying costs paid to or on behalf of a covered employee.

To receive the deduction, the following requirements must be met:

1. The qualifying costs are paid to or on behalf of a ***covered employee***;

2. There is a ***written professional employment agreement*** between the PEO and the client; and

3. The PEO is ***performing professional employer services.***

Arrangements that do not qualify as PEO arrangements

The following are situations and examples that do not qualify as PEO arrangements.

Paymasters. The term "paymaster" typically refers to a person that acts as an agent for the purpose of paying the employer obligations of one or more clients. A paymaster may or may not be affiliated with its clients. A paymaster is, in general, a person who is not an employer of the employees and who has none of the rights or obligations of an employer. In contrast, a PEO is a coemployer with rights and obligations of an employer that are specifically identified in a contract with the client. For deductions related to paymasters see RCW 82.04.43393 and/or ETA 3181.2013.

Staffing services. RCW 82.04.540 provides that "staffing services" means services of a person who:

(i) Recruits and hires its own employees;
(ii) Finds other organizations that need the services of those employees;
(iii) Assigns those employees on a temporary basis to perform work at or services for the other organizations to support or supplement the other organizations' workforces, or to provide assistance in special work situations such as, but not limited to, employee absences, skill shortages, seasonal workloads, or to perform special assignments or projects, all under the direction and supervision of the customer; and
(iv) Customarily attempts to reassign the employees to other organizations when they finish each assignment.

For information regarding staffing company reporting requirements see ETA 3100.2009 and the Department's online Staffing Industry guide.

Responsible for the services provided. Where the taxpayer is obligated to perform

services (other than professional employer services) or is responsible for the performance, the taxpayer is not acting as a PEO with respect to the employees providing the services.

Examples for arrangements that do not qualify as PEO arrangements:

1. Entertainment Company provides services to Night Club. Entertainment Company's services include managing Night Club on an ongoing basis; including providing staff to operate Night Club and making daily decisions about the work schedule and events. Night Club is identified in the written contract as an employer and is allocated a material portion of the rights, duties and obligations (such that the professional employer agreement requirement would be met). Here, Entertainment Company is obligated to provide the services that the employees are performing for Night Club. Thus, Entertainment Company is providing management services, not providing professional employer services.

2. Company A has an agreement where it is provides medical services to Company B. Company A does not have a license to practice medicine so it contracts with Company C to provide the services. Company A and C enter an agreement in which Company C agrees to provide the services to Company B. Further, Company A agrees to act as the PEO for Company C's employees. Company A is not entitled to a PEO deduction for the amounts it receives to pay Company C's employees because Company A is obligated to provide the services and has hired an independent contractor to fulfill this obligation. Therefore, Company A is responsible for the performance of the services and cannot deduct this cost of doing business.

Sharing of employees among commonly-owned companies. Arrangements wherein a person, whose principal business activity is not entering into professional employer arrangements and which does not hold itself out as a professional employer organization, shares employees with a commonly-owned company within the meaning of section 414(b) and (c) of the Internal Revenue Code of 1986, as amended. Such a person is not acting as a PEO with respect to the shared employees.

Covered employees requirement

Covered Employees are individuals who are coemployed by a PEO and its client. An individual is a covered employee when both of the following are satisfied:

- The individual employee receives written notice of the coemployment with the PEO.

  Although there is no specific language required, the notice must clearly identify the PEO and the client. Further, it must put the individual employee on notice, either actual or constructive, that the employee is co-employed by both the PEO and the client.

- The individual employee's co-employment relationship is pursuant to a professional employer agreement between the PEO and its client.

The individual employee does not need to be furnished with a copy of the agreement nor does the employee necessarily need to be made aware of the actual terms of the agreement. However, there must be a professional employer agreement that meets the requirements of the statute (described below under "Professional employer agreement").

The client's directors, shareholders, partners, and managers may be covered employees if:

- The PEO and the client have expressly agreed in the professional employer agreement that such individuals are covered employees, and
- They are operational managers or perform day-to-day operational services for the client.

An employee cannot be coemployed by more than one client. In other words, an employee can only be coemployed by one client and one PEO.

Examples for use in determining if there are covered employees:

3. Hospital enters into a contract with PEO that provides for the coemployment of Hospital's employees. The agreement is in writing, is signed by both Hospital and PEO, and otherwise meets the requirements of a professional employer agreement. The employees are not given a copy of the agreement. PEO is listed in the employee handbook as a PEO (or is adequately described as operating like a PEO) and the employee's paystubs contain PEO's name. This is sufficient notice to the employee of co-employment by the PEO, meeting the covered employee requirement.

Professional employer agreement requirement

A **professional employer agreement** is a written contract between a client and a PEO that establishes the coemployment relationship. In order to adequately establish the relationship, the agreement must meet **all** of the following:

- Anticipate an ongoing, rather than temporary or project-specific relationship;
- Provide for the coemployment of covered employees; and
- Allocate employer rights and obligations between the client and the PEO with respect to the covered employees.

An agreement provides for the coemployment of covered employees only if it identifies both the client and the PEO as co-employers. The agreement need not use the term "co-employment" or a similar term, but the agreement must adequately describe and clearly establish that both the PEO and the client have an employer relationship with – and corresponding employer obligations to – the employee. **The client may not disclaim employer status in the agreement or in any other context.**

Further, the agreement must allocate the rights, duties, and obligations between the client and the PEO such that each maintains, to some material degree, rights, duties and obligations of an employer. The client cannot have only nominal rights, duties and obligations. The client must also be entitled to enforce any right or perform any obligation of an employer that is not specifically allocated to the PEO by the professional employer agreement or applicable state law.

A PEO can enter into professional employer agreements with multiple clients so long as there is only one client per agreement.

Examples for use in evaluating the professional employer agreement:

4. To increase efficiency and decrease costs, a restaurant owner enters into a written agreement where employer rights, duties and responsibilities are all allocated to the PEO. The agreement does not specifically list the rights or duties that are allocated to the PEO. The agreement includes the phrase: "all rights that are not specifically allocated to PEO are retained by restaurant owner." This is not a valid professional employer agreement because the rights, duties and obligations are not actually being shared by the parties, even if there may be some nominal rights retained by the restaurant by default. Here, the restaurant does not retain, to a material degree, some rights, duties and obligations of an employer.

5. Same facts as example 4 except that the agreement allocates some employer rights, duties and obligations to the restaurant owner. Under the agreement, the PEO agrees to pay employee salaries, benefits, and other qualifying costs, and may also recruit and hire the employees. The restaurant owner retains firing, compensation and scheduling control. Both parties are identified as employers in the agreement. The PEO and the restaurant owner parties have executed a valid professional employer agreement.

6. A company enters into an agreement with Hospital. The agreement states that the company will provide all staff necessary for the operation of the Hospital. The agreement further states that the company will be the employer of all staff. Hospital is never referred to or treated as an employer in the agreement. This is a sale of employee labor and there is no valid professional services agreement because the parties are not clearly identified as coemployers who share employer responsibilities.

Professional employer services requirement

The PEO must be engaged in the business of entering into coemployment relationship(s) with client(s), in which all or a majority of the employees are covered.

Example for professional employer services:

7. A PEO and Client enter into a professional employer agreement that meets all of the statutory requirements. The agreement covers 40 employees (i.e. the PEO and Client are coemployers of only 40 employees). Client has an additional 60 employees that are not covered by the agreement. No deduction is allowed since a majority of Client's employees are not "covered employees."

See section on "arrangements that do not qualify as PEO arrangements" for examples of when this requirement is not met.

Sales between clients

The following is an example of an arrangement between entities where a portion of the payment to cover employee costs is paid to an affiliate instead of the entity selling the services. This example is meant to explain the tax consequences to the selling entity but it also briefly describes why the affiliate may not qualify as PEO.

Example for sales between clients:

8. A property management company sells comprehensive property management services to an owner of property. The contract for management services requires the management company to provide all employees necessary to staff and operate the property. The owner pays the management company a set monthly fee for these services.

   Assume that the management company creates Affiliate to pay employees. Assume also that the management company, the property owner, and Affiliate all enter into an agreement under which the management company and the owner are joint co-employers in a coemployment relationship with the Affiliate. Under this agreement, the management company and the owner, jointly, have all rights and obligations not expressly allocated to the Affiliate under the co-employment agreement. Because there is more than one client under this agreement, Affiliate does not qualify as a PEO.

   In addition, the agreement requires the owner to pay directly to the Affiliate all amounts necessary to cover the actual costs of wages and salaries, benefits, workers' compensation, payroll taxes, withholding, or other assessments paid to or on behalf of the employees staffing and operating the property.

   The management company must include in gross income both the monthly fee it receives directly from the owner, and the amount the owner pays to the Affiliate to cover the actual employment costs of the employees staffing and operating the property. This is because the management company is selling comprehensive property management services, and the employment costs of the employees are a non-deductible cost of its business. The amounts paid to the Affiliate by the owner are consideration to the management company and considered gross income of the business under RCW 82.04.090.

The management company would be similarly taxed had Affiliate qualified as a PEO.