So, you’re considering outsourcing your payroll and benefits to a PEO and you want to find out more about how they work. Type “Professional Employer Organization” or “PEO” into any search engine and you will get a listing of hundreds of PEOs and nearly as many articles extolling their benefits. Take a closer look at those glowing testimonials and you’ll find the majority of them are written by the National Association of Professional Employer Organizations (NAPEO), a PEO, or Outsourcing.com, an organization promoting outsourcing companies, including many PEOs.

As you might imagine, these articles can be a bit biased. While there are many valid reasons to subscribe to a PEO, there are just as many good reasons not to. A relationship with a reputable PEO may be just the ticket for your business, but before you make that leap, be aware of the myths, misconceptions, and pitfalls that get lost in all the hype.

**Does a PEO really save you money?** To make a true evaluation, you need to fully understand what services they can and will provide and how you will be billed for those services. Some PEOs charge a percentage of gross payroll, while others bill based on your workers’ compensation or charge a per-employee check fee. That may seem straightforward enough, but buried in the details of the PEO process are many hidden or misunderstood charges that can significantly impact an employer’s cost analysis.

**Does a PEO really save you time?** PEOs often speak to the advantage of having a single administrative contact, and it is a compelling attribute. However, many PEOs are very static with their offerings and this bundled approach of delivering products and services can actually create a complicated maze of access points.

**Does a PEO really provide broad and comprehensive products and services?** Not all PEOs are the same. Some provide quality products and services that serve many of their clients well. But other PEOs are rigid and limited in their capabilities and are able to meet the needs of only a limited sector of the business community.

Whether or not a PEO can save you money and time while delivering a comprehensive list of desired products and services depends on a number of factors. The following are some of these factors to consider when making your own analysis.

**STARTING WITH A PEO**

The first day of the PEO contract is in force, you and all of your employees will have a new employer. As your new “co-employer” the PEO becomes the employer of record and all of your employees must be “hired” again, including yourself. This means new hire paperwork, new tax forms, new benefits enrollment forms, new employee manual, new everything. Good PEOs do all they can to make this transition as smooth as possible, but it is never easy — for you or your staff. And it could cost you more than you know.

**TAXES**

If you already have employees when signing up with a PEO, you may be signing on to pay Uncle Sam that much more. Switching employees over to a new employer-of-record will roll everything back to zero where cut-off limits on taxes are concerned, even if the transition occurs in same calendar year.

For stand alone employers, most employer taxes have limits: you only pay the taxes on a defined portion of an employee’s wages. For example:

- **FICA O** (Social Security) The employer pays 6.2% taxes on $94,200 of adjusted gross wages.
- **FUTA** The employer pays .8% taxes on the first $7,000 of adjusted gross wages.
• **SUTA** The employer pays approximately 3.4% taxes on the first $7,000 of adjusted gross wages.

But, for employers with PEOs, tax cutoffs may be irrelevant. Some PEOs will continue to collect employer taxes even after the limits have been reached. They continue to take these monies as profit. It’s one of many revenue streams that can add up.

**WORKERS’ COMPENSATION**
Companies signing on with PEOs are often under the impression that their workers’ compensation premiums will be reduced. Depending on your experience modification and the market, association with a PEO may or may not save you money.

If you’re a safe company — you do not have many work-related accidents and open workers’ comp claims — you may already have a low experience modification rate. In this case, joining a PEO may cost you more money depending on whether the PEO gives you the benefit of your existing rate.

Another potential pitfall in joining a PEO occurs when the insurance market is adjusting and rates are coming down. Since the PEO is the employer of record, it is their normal anniversary date that dictates when new rates go into effect. The rate reduction being passed on to the client company can be delayed up to a year.

Like taxes, workers’ comp has certain cutoffs and not all wages are subject to premium calculations. Workers comp premiums should:

- Be billed based only on adjusted gross wages.
- Be billed on straight time, not overtime.
- Not be billed or paid on any type of severance pay.
- Be cutoff at the cap for officers and owners of the company. This is a significant issue for companies with highly compensated officers/owners. Currently, the current cutoff is $87,100.00. Any monies earned over the cutoff limit should not be included in premium calculations.
- Be treated as optional for owners of an LLC, partnership, or sole proprietorship.

There are many other nuances to consider depending on the employer’s state and the complexities of the business including: military duty, prevailing wage, treatment of first aid, a lack of direct contact with claims adjustors and insurance representatives, the employers ability to positively impact its own experience, ownership of the employers’ experience for its own benefit, and many other important factors. These issues, coupled with the size of the company, can be very important in the long term analysis of the benefits of a PEO relationship.

**RISK MANAGEMENT FEES**
Some PEOs charge an additional fee to help manage “your” risk. However, as discussed later in this article, it is the work-site employer who is liable for any employee-related issues. To protect your company, you may be paying to cover the PEO’s Employer Liability Insurance on top of your own Employer Professional Liability Insurance. In addition, when an employer has a direct or brokerage relationship with insurance companies, many customized risk-management functions are provided free of charge. Leveraging the same or similar types of services through a PEO can be difficult at best.

**ADJUSTED GROSS WAGES**
If your company has a Section 125 Premium Only Plan (POP), or a Flexible Spending Account (FSA), employee deductions under these plans reduce your wage basis for purposes of taxes and workers’ compensation. The IRS’s intent was to provide an incentive to employers to offer these benefits and help them offset their administrative costs.
fees through tax reduction. For employees participating in these plans, their taxable wage base is reduced for qualifying deductions.

For example, basic wage calculations for an employee on a typical check might look like this:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Wages</td>
<td>$2,500.00</td>
</tr>
<tr>
<td>Employee Benefits</td>
<td>(300.00)</td>
</tr>
<tr>
<td>FSA</td>
<td>(200.00)</td>
</tr>
<tr>
<td>Adjusted Wages</td>
<td>$2,000.00</td>
</tr>
</tbody>
</table>

Even though taxes and workers comp premiums are typically calculated on adjusted gross wages, a PEO may assess them based on the higher gross wages. If you're in a moderate risk group for workers' comp, paying a combined 15% for taxes and workers comp premiums, you might be paying 15% of $2,500 ($375) instead of 15% of $2,000 ($300). Multiply the difference by the number of employees and it adds up quickly, for you and the PEO. And the revenue generated for the PEO is on top of your administrative fees.

**ELIMINATE EMPLOYER LIABILITY**

PEOs often say that becoming the employer of record eliminates your liability. However this is not a true statement, even according to NAPEO. “The PEO will generally only assume responsibilities and liabilities associated with a ‘general’ employer for purposes of administration, payroll, taxes and benefits. The client will continue to have responsibility for workplace safety and compliance.”

So, even with a PEO, you — the site employer — still have the same responsibilities you had before and maybe more (see OSHA and Cal-OSHA). If an employee decides to sue for wrongful termination, sexual harassment, or discrimination, you will still be held liable, and the likelihood is that both you and the PEO will get sued. In the case of an OSHA violation, however, only you will be held liable, as you are the entity responsible for the physical location and any associated hazards.

Depending on the size of your business, joining a PEO may actually add additional liability to a company. As an independent employer, you may have less than 50 or 100 employees, but as part of a PEO, you’re held to the same standards as a large company. For example, an employer with 50 or more employees is required to provide sexual harassment training to all their managers, supervisors and leads. They are also subject to FMLA and CFRA and must continue to pay for benefits when an employee goes on medical leave. Employers with 100 or more employees must file an additional report annually with EEOC. As part of a PEO, even if your business has less than 50 employees, you can be held to these same standards, and more under OSHA and Cal-OSHA.

At the very least, before signing, check with the PEO to ensure they are going to bear the exposure of the size differential and any related penalties should an agency audit you.

**OSHA AND CAL-OSHA**

Requirements under OSHA and Cal-OSHA can also increase for small companies partnered with PEOs. In most cases, Illness & Injury Prevention Programs, Chemical Hazard Communications Programs and other written plans are required of employers with 10 or more employees. But when a small company joins a PEO, they are required by law to have these plans as well as other procedures, including on-site inspections, corrective actions, and documentation. If providing OSHA and Cal-OSHA support and services was standard for PEOs, this might not be much of an issue, but they don’t. And, again, as the site employer, the additional liability and exposure is yours to bear.

**EMPLOYEE BENEFITS**

When it comes to benefits, PEOs talk a lot about their “economies of scale,” the benefits of a large insurance pool, and “Fortune 500” offerings. They would have you believe that they can provide benefits of a caliber that would normally be well out of reach for small businesses, and offer them at rates they would never qualify for on their own. But benefits through a PEO aren’t always a bargain.

Contrary to what they would have you believe, employers with under 50 employees can offer their employees a variety of plans on their own, including choices in carrier, plan, design, and type. Affordable medical, dental, vision and life insurance administered through a single administrative source is available to small and mid-sized businesses at affordable prices. Larger groups have even more control over their benefits and can often design their own plans.

As for the cost of benefits, whether or not you’re going to save money with a PEO depends on your demograph-
ics. If the majority of your benefits-eligible employees are fairly young, you may actually see an increase in the cost when signing on with a PEO, especially if that PEO has had a bad claim year. Benefit prices through a PEO are based on the experience of their entire client base. So, if the collective PEO group experienced a significant amount of large or recurring claims, the PEO price might actually be higher than if you went shopping for plans on your own with a healthy group of employees.

Perhaps the biggest issue with benefits through a PEO is the complete lack of control over carrier selection and the types of plans offered. If the PEO determines that the rates are too high, they will decide what carriers and plan designs to offer and, unless your business represents a significant portion of business for the PEO, they won’t consult you. These new plans may not cover as much as they once did, and they may or may not have the same physicians, hospitals, or service areas, but you have no recourse. This can have a negative impact on moral issues and turnover.

**LOSS OF AUTHORITY AND IDENTITY**

Once you join a PEO, technically, you and your employees work for the PEO. They aggregate all insurance plans under their tax id. They will be the entity doing the hiring and firing, and their name will be on everyone’s paychecks and tax information. They will also be providing your employees with benefits, but the insurance plans offered will represent what is best for the PEO’s client base, which may or may not meet your company’s needs.

Besides losing your identity with your employees, you may lose authority with them as well. Remember, you are a co-employer with the PEO, and they often reserve the right to hire, fire, reassign, direct and control your employees. PEOs maintain that they manage human resource functions and compliance so that the site-employer can focus on producing its products and services, but for some companies, the loss of control over how employees are managed can be problematic and, ultimately, detrimental.

**SINGLE POINT OF CONTACT**

On the surface, having one company perform all of your back office administration sounds great. After all, how nice would it be to enter a new hire into one system and let the PEO do the rest? It all sounds so easy. The only problem is that single point of contact comes with a bundled set of services and service providers. So, if you’re unhappy with one or more of the services, there isn’t much you can do. It’s all or nothing. So, when you become unhappy with payroll, or your managers can’t get timely support, or your employees are unhappy with the insurance, and you decide it’s time to chose “nothing,” well, that’s not as easy as it seems either.

**TERMINATING A PEO**

There are numerous reasons employers decide to leave the PEO model: realized cost, incompatible benefit offerings, growth of the employer, lack of service, and others. Before deciding to partner with a PEO as a co-employer, an employer should consider the barriers to exiting:

- **All New Paperwork** The day following the termination of the PEO contract you will be a brand new employer and will have to reestablish yourself as such. Your employees will have to complete all of their new hire paperwork again. They will have to re-enroll in benefits as well.

- **Two W-2s** Your employees will receive two W-2s for the year, which can confuse and alienate them.

- **Taxes** Your employees will start FICA and SDI deductions all over again, even if they had reached cutoffs while with the PEO.

- **More Taxes** As their employer, you will start paying taxes over again for all your employees, even if you had already met all the cutoffs under the PEO. Unlike the employees, you will not receive a refund from Uncle Sam at the end of the year, because you are a new employer in their eyes.

- **Benefits** A long term relationship with a PEO may make complicate the search for new benefit plans as many insurance carriers require proof of employment by showing a full quarter DE6.

- **Workers Compensation** If you’ve been with a PEO for a long time, you may also find it difficult to secure competitive workers comp insurance. Most carriers want to see your premium and loss experience to determine if you’re a good or a poor risk, which may not be possible. You may end up paying a higher rate due to the lack of history or be forced to
go with the state plan.

So, if you make the decision to sign up with a PEO, but decide to leave for any reason, there will be some challenges in transitioning back to a single employer.

TO PEO OR NOT

With all that said, there are some very good reasons to partner with an established PEO:

- If you have a small company that is not going to experience significant growth.
- If your workers’ compensation and related risk-management needs are straightforward and require little or no assistance from outside parties.
- If employee benefits are not important to your growth, stability, or long term goals.
- If you’d be more comfortable handing over control of your human resource management and your employees.

For most companies, however, a PEO is not the answer to all of their challenges. As you’ve read, a PEO actually has the potential to create a few more, and cost them more money and valuable human resources in the process.

BUYER BEWARE

If you are considering a PEO relationship, know who you are getting involved with. Ask for references and call them. Ask for the numbers of businesses who are no longer using them and call them, too. Since this is the business that is essentially going to turn around and hire you and your employees, you need to make sure you want to hire them.

If you do sign up, read all of the fine print first. Then have your lawyer read it. Make sure you understand what services you’re receiving, what you’re not receiving, what rights you’re giving up, and what liabilities you’re taking on.

MAKE SURE YOU UNDERSTAND THE PRICING STRUCTURE. If you’re not up to speed on the finer points of employee taxes, workers’ compensation premium calculations, and employee benefit design and delivery, find someone who is and have them read it and explain it to you.

If the only reason you’re considering a PEO is for administration relief, or to have a single point of contact, look at a Business Processing Outsourcing (BPO) model, a competitive alternative to PEOs. Many companies have made all the offerings available under a PEO available using a single system, but using different providers. This option allows you to retain your status as an employer, including your identity, your control, and direct access these products as needed, rather than as an “all or nothing” product.

You can be an effective professional employer without using a Professional Employer Organization.

ABOUT THE AUTHOR

After spending years in executive positions at TriNet, a PEO based in Northern California, and ProLease (now PayStaff), a PEO based on the east coast, Deisy Bach founded HRI, an outsourced human resources provider, specializing in the creation and delivery of progressive and innovative solutions to human resource issues and challenges.

HRI offers a comprehensive menu of consulting and outsourced human resources services, including:

- On- and off-site support;
- Handbook & policy development;
- Sexual harassment training and mediation;
- OSHA compliance;
- MSDS, IIPP and Safety plans;
- Employment law training & seminars;
- Safety compliance & training classes;
- Workers’ comp management
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HRI products and services are designed to help businesses of all sizes effectively manage and reduce the liability and exposure inherent in day-to-day operations.

For more information about this article or Deisy Bach and HRI, visit at www.HRIideas.com or call 925.556.4404.