



PROFESSIONAL EMPLOYERS FOR SMALL COMPANIES

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Small and mid-sized companies can rid themselves of time-consuming administrative functions and save costs on benefits packages by outsourcing their human resources functions to a Professional Employer Organization (PEO)

More and more small to mid-sized companies are outsourcing their human resources functions to professional management firms. Known as **Professional Employer Organizations (PEOs)**, these companies are saving clients time and money, increasing employee morale, and reducing their liabilities as an employer. The PEO undertakes every function of an employer's human resources responsibilities - payroll, benefits, Section 125 cafeteria plans, workers' compensation, unemployment claims, compliance, record keeping, payroll taxes, 401(k) pensions plans, and so on. Because the client then has one source for all of these services and enjoys the convenience of simply paying one invoice per pay period for all the services, it can spend more time on growing the business.

Unlike the employee-leasing companies, PEOs become "co-employers" with their client companies. Employee-leasing companies differ in that they actually become the "sole employer". PEOs tend to focus more on human resources and comprehensive benefits, and that focus attracts more executives, technology professionals, and light manufacturing companies. Employee-leasing firms tend to work best for union shops, trucking, and construction companies.

The concept of co-employment has been around for more than 20 years and was officially recognized by the IRS back in 1993 (see section 414N of the IRC). Under this arrangement, the client is the employer for all day-to-day management of staff. The PEO becomes the administrative employer and is responsible for providing payroll, filing taxes and associated reports, record keeping, and labor law compliance. *The PEO simply becomes the off-site human resources department. This arrangement is similar to any Fortune 500 company that has its HR staff physically located at its headquarters with many locations all over the country.*

BIG BUSINESS BENEFITS

PEOs provide expertise, compliance, and the services of a Fortune 500 HR department. Studies have demonstrated that most employees prefer the opportunities and friendly atmosphere of working for a smaller company, but they tend to compromise this preference with a desire for the comprehensive benefits packages of Fortune 500 companies. PEOs enable the small employer to compete on a level field.

When you consider that the client will benefit from access to comprehensive benefits packages at wholesale rates, it makes the PEO even more attractive. It is not uncommon for a quality PEO to upgrade the health plan and implement a dental and 401(k) plan for the same money the client was already spending on its old package.

Professional management helps retain quality employees. Unmanaged employee turnover can steal a company's knowledge base, profits, and competitive edge in a market. Estimates of the total cost of quality employee turnover range from a low of 50% to 60% (The Hay Group) to 100% to 150% (Hewitt Associates) of the employee's annual compensation. *The Wall Street Journal* reported that mid-1997 employee turnover was up sharply from the year before with 1.2% of the workforce leaving each month. Employees consistently state that benefits are one of the most pertinent factors in their decision to stay.

THE INSURANCE ADVANTAGE

With a PEO, a business owner no longer has the deal with a payroll company and several commission-based insurance producers as a single customer. The client benefits from the expertise and buying power of the larger entity. PEOs aggregate all of their clients and, therefore, are able to negotiate advantageous deals with the insurance industry. Insurance companies provide discounts to PEOs based on volume and economies of scale. They acknowledge the PEOs are consistently adding new employees, and they appreciate efficiencies created by dealing with one entity, the PEO, instead of with the scores of individual billings and brokers normally associated with the small business market. PEOs can reduce health, dental, vision, and workers' compensation insurance premiums by 10%-50%.

PEOs increase the survival rate for the small employer. By letting the PEO professional take care of employee files, immigration records, and so on, the entrepreneur can remain creative. Businesses are created by people who have a vision, motivation, and an entrepreneurial spirit--no one starts a business simply to become an "employer." PEOs take on the role of "employer" so that the employees get the same attention and benefits packages as a blue-chip company.

Typical small employers risk their own capital, work as many hours as needed, create jobs, provide benefits for their employees, and also are required by law to be fully responsible for signing the paychecks, remitting the proper taxes, matching the FICA, paying the SUI and FUTA, paying for workers' compensation insurance --- just to stay in business. If every one of the above-mentioned chores is not filed accurately and on time, the employer can be subject to fines, penalties, and the risk of being closed down. Yet, none of these tasks generates any profits for the business owner. Not only are business owners personally liable, they also incur substantial administrative costs. This is what makes the PEO concept so attractive.

James O'Brien, an attorney/CPA and CFO of a leading graphic arts company with 60 employees in New York City, has been outsourcing with a PEO for a year now. "When I first learned of the PEO industry, my first reaction was 'what a great idea; why didn't they think of this sooner?' The administration demands really were taking a toll on my staff. Now, I simply send one wire per pay period, and the PEO handles all of the tedious paperwork and pays attention to all of my employees' needs". O'Brien also points to the savings in time and other costs. "Due to our size, we were paying retail rates for basic health insurance coverage. Not only did they implement a more comprehensive benefits package that included dental and a 401(k) plan, we actually realized enough savings to absorb most of their fee."

RECORD KEEPING AND COMPLIANCE

Just as with the human resources department of any large corporation, all employees files are kept at the PEO's location – immigration I-9 forms, personnel records, W-4s, health applications, payroll records, overtime compliance, job application, terminations, and so on. Because the payroll is being drawn out of the PEO's bank account, all of these compliance issues are regarded as the PEO's responsibility.

Today's business owners often are more concerned with quality employees, medical plan costs, regulatory compliance, and worker's compensation than strategic issues like marketing their services and maximizing profitability. That is why for those companies that cannot afford in-house HR departments PEOs may be a viable option.

Most small businesses are familiar with the employee burden rate, that is, the percentage above gross payroll that it costs an employer to have employees - relating to everything from statutory taxes to the time it takes to explain the health plan to a new employee. For a clerical employee this rate ranges from 15% to 19% above gross payroll. In effect, for every \$100 in payroll it costs an employer an additional \$15-\$19 to have that employee work for the company. This rate does not include any additional benefits it may offer such as health, dental, or 401(k) plans. (See Table 1)

TABLE 1: EMPLOYER BURDEN RATE COMPONENTS

Social Security	6.20%
Medicare	1.45%
Federal Unemployment Tax	0.80%
State Unemployment Tax	1.50% to 7.00%
Workers' Compensation Insurance	0.28% to 30.00%
Payroll Processing Costs	0.50% to 1.00%
Administration Costs (section 125)	0.50% to 2.00%
Accounting Costs	0.50% to 1.00%

Other costs include the very real, but difficult to measure, costs in time, opportunity, and liability.

- Costs incurred procuring and explaining the benefits package,
- Costs to create and update job descriptions,
- Handling unemployment claims (legal counsel?)
- Handling workers' compensation claims (legal counsel?)
- Legal fees to defend against employee lawsuits,
- Space incurred by the employees files,
- Lost productivity due to turnover of key employees, and
- Department of Labor fines and IRS late payments fees.

When you consider all the taxes, time, effort, and liabilities of employing people, you can see why it costs an additional 19% above the gross payroll for an employee. So a \$25,000/year employee actually costs the company \$29,750. This is before a company even considers extending any fringe benefits.

UNEMPLOYMENT CLAIMS AND COMPENSATION AUDITS

A misunderstood - and often mishandled - part of the employer's payroll burden is the state unemployment insurance (SUI). PEOs actively manage all of these claims while small employers often lack the expertise and the time to fight a nondeserving claim. Few employers realize how their bottom line is affected by letting their rate increase haphazardly. We have met many business owners who are very particular about where every penny goes, yet they are paying an extra 2%-3% of payroll in SUI because they were not aware of how the systems works. When a company has a poor SUI rate due to negligence, it can take three to five years to have it reduced. When a company hires a PEO, it no longer has a SUI rate. It gets to benefit from the PEO 's existing, professionally managed rate.

If workers' compensation insurance is based on payroll, why not pay it with payroll? PEO clients no longer have workers' comp audits. The billing system is such that the premiums are built into the pay periods. Workers' compensation is included as one of the statutory requirements that a PEO provides its co-employees. PEOs are experts at purchasing and administering workers' compensation. Insurance carriers offer discounts to PEOs because PEOs limit paperwork and are proactive in safety and fraud detection as well as assist in managing and directing care. A quality PEO usually has its own medical director, attorneys, and safety experts to keep claims from getting out of hand. Small employers also benefit from their workers' comp professionals working on their behalf.

A full-service PEO enables every employee and his/her spouse the opportunity to contact their own designated personnel manager. Employees get answers when they have questions regarding their paycheck, dental plan, out-of-net work deductibles, remaining vacation days, and disability plans. The employers are no longer spending valuable time tracking down brokers or looking through handbooks to arrive at answers that they are usually uncomfortable providing.

PEO SERVICE COSTS

The fees for a PEO will range from 2% to 5% of gross payroll depending on the profile of the client. Some PEOs will calculate the payroll tax burdens and will add the fee to each invoice, which is paid with every pay period.

The more popular method is the "bundled bill rate" method. This bill rate, which bundles in all employer burden components and the PEO's fee, is simply multiplied times gross payroll. It enables the client to have a known cost of labor that will not fluctuate with turnover, new hires, unemployment, and workers' compensation claims. The bill rate, which does not fluctuate during the year, factors in all the variables and costs of the employer burden components. When a bill rate is set at a fixed rate of gross payroll, the employer will know that his or her payroll costs will be the same in January as they are in November. This knowledge is particularly valuable to a rapidly growing company that a needs to consistently add new hires. It also simplifies any attempts at cost accounting. If a bill rate is set at 17%, the employer knows that hiring a \$10.00/hour worker will cost exactly \$11.70/hour- adding three new employees totaling \$100,000 in gross payroll will cost exactly \$117,000/year. This includes everything from the time it takes to explain company policies to the cost of printing the paychecks.

A small employer who is working with a PEO no longer has any payroll taxes or workers' compensation insurance obligations - another benefit of retaining a PEO. The PEO is legally responsible for all statutory taxes and insurance obligations such as FICA, FUTA, SUTA, and workers' compensation. The payroll checks still have the client's name on them, but the checks are drawn on the PEO's account. The government likes this concept because it can collect its taxes electronically (in one to three days) from one large, sophisticated entity instead of hundreds of little companies. The client simply wires the money to the PEO and gets back to running the business. There are no more weekly paychecks to reconcile, 941 forms to complete, or disability claims to file. The Client Company gets one simple invoice and pays it just like any other expense such as the rent or the phone bill. The accountant categorizes this expense under "cost of labor" under IRC Section 162 and included in Schedule A, Line 3 on Form 1120, simplifying the internal accounting.

WHEN A PEO DOESN'T FIT

A PEO is not for every business. If a company has more than 500 employees, it usually prefers to have its own HR staff, and it should be large enough to leverage some buying power. There are other scenarios where, perhaps, a semi-retired family member has a strong background in HR and accounting and enjoys the challenge.

Awareness of the professional employer industry is growing rapidly, and many companies, including CPA firms, are creating strategic alliances with local PEOs. Small employers, especially profitable companies that are searching for ways to recruit and keep quality employees, may want to investigate this comprehensive service that will save them time and money and reduce their employer liabilities.

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