SYMMETRY
HR Outsourcing

THE PERILS OF PEO'S

What the Employee Leasing Promise Never Tells You

A White Paper from Symmetry HR Outsourcing

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CONTENTS

Overview

At first glance, employee leasing is a great opportunity to streamline your business operations and simplify your structure. In fact, what could be better than outsourcing your labor and employee-management tasks? When you use employee leasing, you will have peace of mind and simplicity. Your liability will be limited, and your benefits will be more affordable. Plus, you will have wider access to insurance programs.

Sounds like a no-brainer, right?

Not so fast. Much like that second person you dated in college, the list of upsides are seemingly long, but understanding the downsides of PEOs can help you decide whether employee leasing is truly right for you.

What is Employee Leasing?

The acronym "PEO" stands for Professional Employer Organization. Originally referred to as "employee leasing", a PEO is a firm that provides a service under which an employer can outsource many employee-management tasks, such as:

- Payroll/human resources management systems
- Workers' compensation
- Online training
- Employee assistance programs
- Employee health benefits
- 401(k) plans, 403(b) plans, and FSAs
- HR and compliance support
- SUI, FUTA, and associated taxes
- Recruiting
- Online training programs and development
- Risk/safety management

The PEO does this by "hiring" a client company's employees, thus becoming their employer-of-record for tax purposes and insurance purposes.

Most PEOs charge in the neighborhood of $200 per employee per month. In addition to this fee, they often reap the benefits of kickbacks from 401(k) providers, as well as the tax benefits of Section 125, so when all is said and done, they earn about $350 per month from each of your employees.

The Upsides

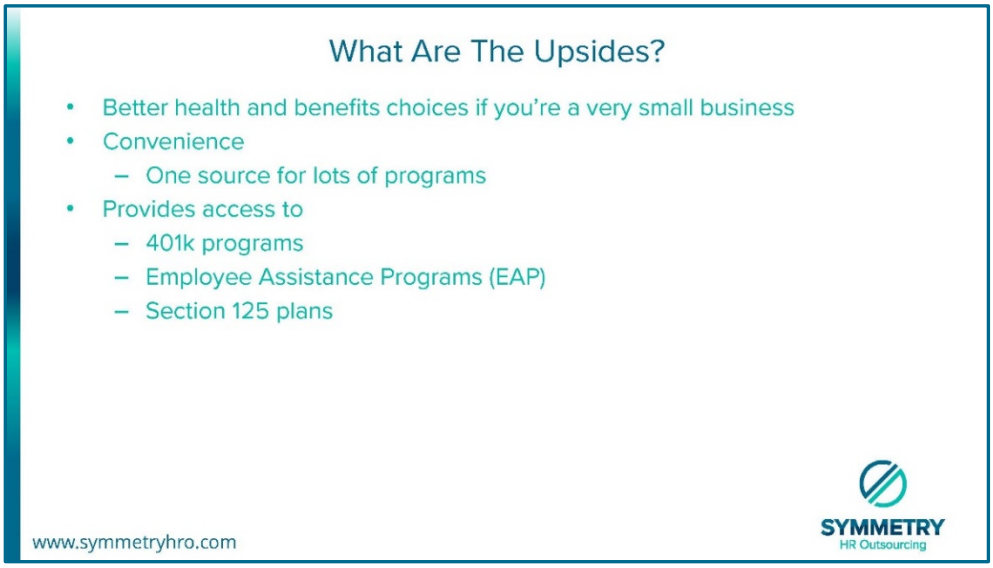
When you use a PEO, you transfer your employees so that they are no longer listed under your employee tax number and unemployment number. Rather, they are listed as employees of the PEO. Because they are part of a larger company, you are able to access better benefits—such as medical and dental insurance, as well as 401(k) plans, EAPs, and Section 125 plans.

Beyond that, you can focus on running your business. If your employee has a question about their 401(k) plan, for instance, they call an 800 number to find the answer. All those questions—and the paperwork—associated with payroll, accounting, and benefits are redirected to the PEO, no longer draining your time or attention.

Instead of focusing on the little things, you can focus on keeping your business competitive and profitable.

You might also save money. Because you are part of a larger pool of employees, the PEOs can consolidate benefit costs and pass the savings to you. They also provide human resources and training material, saving you the time and expense of producing your own. And because the PEO is the employer of record, your liability is reduced, particularly because the large PEO handles compliance with rules and regulations.

In short, the unmitigated convenience of a PEO makes it attractive for many small businesses.



Which Business Might Benefit from Employee Leasing?

PEOs are selective about their clients, so not every business will qualify.

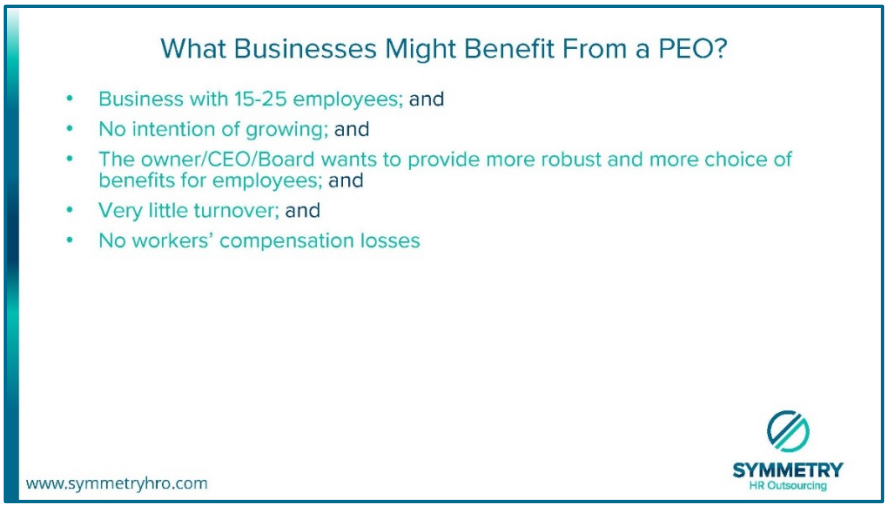
The first criterion considered is workers' compensation. Because PEOs become the employer-of-record, they do not want clients who have exposure for workers' compensation loss. Remember: PEOs employee have multiple clients. If an employee leased to your company receives workers' compensation as a result of something that happened while on the job, the PEO will have its own workers' compensation rates increased, and it will have to raise rates for all of its clients.

If you have employees working in the field, at educational institutions, or otherwise employed in activities associated with a lot of potential workers' compensation losses, chances are slim that you will find a PEO.

That said, if you are understaffed and have no central personal managing your HR issues, you might be a good candidate for a PEO, particularly if you have low employee turnover and few (if any) EPL losses.

Hiring and firing people takes time and money. If you have high employee turnover, you're going to have a higher unemployment insurance rate, which will impact the rest of the PEO's clients. Chances are, you also have more lawsuits, which means you will have higher employment practices liability (EPL) rates.

In short, PEOs like small businesses that are in white-collar industries with low turnover.



The Downsides

If you like the sound of the many upsides, and you believe your firm is a strong candidate for a PEO, it's time to consider the downsides.

First of all, keep in mind that no matter how heavily solicited you are, not many companies are accepted as clients by PEO, and those that are accepted might get dropped. Our best guess is that PEOs drop about 25 percent of their clients within the first three years.

Though cost is often listed in the "pros" column, the truth is that if you have more than thirty employees, using a PEO doesn't make financial sense. Once you hit thirty employees, you will be paying so much in fees and services per-head to the PEO that you might as hire a payroll processing firm, benefits broker, and part-time human resources specialist.

(If you're a California employer, be sure to ask your broker about Cal Choice, which might be able to offer a better benefit plan available to your small business at a low cost.)

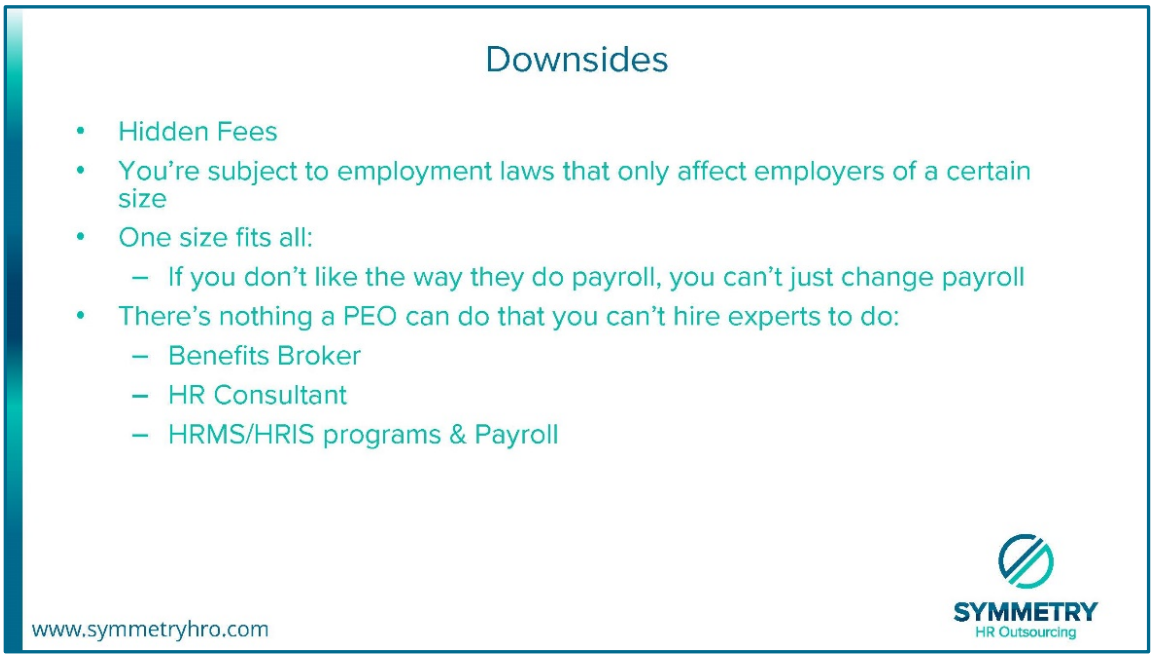
Here are a few of the other downsides:

- As a small business, you will subject to employment laws that only affect large employers. For instance, if you have thirty employees, you are not subject to the Family Medical Leave Act, which requires you to give up to twelve weeks of leave for someone who is ill or for a family member that is sick or pregnant. However, when you join a PEO, all of your workers will be eligible for twelve weeks of paid leave because they are technically employed by the PEO, which has a huge labor force.
- Truth be told, you can probably hire people to do everything a PEO does at the same rate. You can find a great benefits broker, HR consultant, and payroll and HRMS/HRIS program to accomplish everything a PEO accomplishes. In fact, one of our clients enjoyed a $110,000 annual net savings after extracting from a PEO!
- The PEO might insist on being named as an "additional insured" on your liability, auto, and employment practices policies, which is difficult and costly.
- You will need to maintain EPL coverage, but EPL carriers do not like PEOs and will likely raise your premiums ad restrict your coverage terms if you are working with a PEO. The same goes for liability carriers.
- PEOs do not negotiate. If you dislike their payroll services, you cannot switch to a different payroll provider. If you want the baby, you'll have to take the bath water, too.

This brings us to the biggest downside of a PEO, which is this: Once you start offering the benefits of a PEO, you will have a hard time walking, even if the bath water is truly awful. If you give your employees a benefit through a PEO, but you dislike one or two or even three facets of the PEO, you might have to grin and bear it. After all, your workforce won't want to walk away from their great benefits, and it will kill your company's moral to offer a benefit, only to turn around and take that benefit away.

This is particularly troublesome given that PEOs can increase your rates. Oftentimes, for instance, they offer a workers' compensation rate that is attractive—somewhere in the neighborhood of 2.1%, lower than the 3% rate paid by most small companies. But after six months, your rate could be bumped up from 2.1% to 2.9%. And, if they suffer losses with other clients, it might increase to 3.4%.

What will you do when you are no longer reaping the rewards, but your workforce still enjoying those great benefits?



Extracting Yourself from a PEO

A couple of years ago, Symmetry approached by a 50-employee professional services firm in Santa Monica whose executives were concerned that the company was paying too much to the PEO.

We did our research into payroll companies, benefits brokers, 401(k) providers, and the like, and we found that the company was paying $110,000 too much every year—more than one full-time employee.

Extracting from the PEO took us four months, and the work amounted to starting a new business. Why so long?

First, we had to start over from the beginning with workers' compensation, benefits, and the like. Second, the PEO had a clause in its contract that gave it ninety days to provide records and data to the client.

We asked for the client's last runs of January 15, but we did not get it until April. During this ninety-day gap, we fielded more than a few calls from the PEO's aggressive marketing team as to why we were requesting the information, what we planned to do with it, and who could possibly offer payroll and HR expertise to the client.

All of this can be costly, and it can lead to gaps or overlaps in benefits coverage.

In other words, if you think finding a PEO is challenging, just wait until you have to leave a PEO!

Questions to ask a PEO Salesperson

Still, working with a PEO isn't a bad choice for some companies. Be sure to do your due diligence and ask questions that force the PEO salesperson to address the downsides. Here is a list we've compiled for you to ask:

- "Are you local? Where are your headquarters, and where is the local processing center?"
- "How much individual attention do I get?"
- "How many people will I be dealing with insofar as payroll, HR, workers' comp, benefits specialists, etc."?
- "May I meet the key customer service and HR person I'll be dealing with?"
- "Will I be able to choose my own attorney in case of an employee lawsuit?"
- "Do I have complete independent control over all personnel decisions?" (For instance, if a key employee flunks a drug test or gets a DUI, is the personnel decision yours or the PEOs?)
- "Do you allow us to pay employee bonuses without taking a percentage of the bonus check?" (Most PEOs generally refuse to issue bonus checks to employees.)
- "What is my liability and yours in a DLSE, harassment, or EEOC case or lawsuit?"
- "What onsite loss control/prevention services do you offer onsite?"
- "Are we allowed to use 1099s/independent contractors?"
- "Are the employer tax benefits normally associated with the Section 125 program returned to the business?"

For PEOs that charge a percentage of payroll, ask:

- "Do you lower your percentage fee when an employee reaches the wage base limit?"
- "Will you charge me, the owner, if I take a wage?"

The Bottom Line

When it comes to PEOs, know what you are getting into, and how difficult it is to get out of. Be sure you have a compelling reason to join a PEO and that it is worth it to you to make a long-term change. Beyond that, don't rely on the salesperson to give you answers to all of your questions.

And finally, use this checklist when making the choice among the various PEOs out there:

- ✓ Are the benefits and services available useful enough to be worth the additional administrative fees and costs?
- ✓ Does the PEO provide the benefits and services not only I want, but also services I want to pay for? (A business that only wants to offer better benefits and outsource HR administrative work may not want to pay for things like employee recruitment and evaluation tools.)
- ✓ Have I received both client and professional references?
- ✓ Have I checked the firm's financial background, and asked for banking and credit references?
- ✓ Have I investigated the company's administrative and risk management service competence? What experience and depth does its client service/human resources staff have? Do any of the senior staff have professional training or designations?
- ✓ Do I understand how the employee benefits are funded? Is the PEO fully insured or partially self-funded? Who is the third-party administrator (TPA) or carrier? Is its TPA or carrier authorized to do business in your state?

Have I reviewed the service agreement carefully? Are the respective parties' responsibilities and liabilities clearly laid out? What guarantees are provided? What provisions permit me or the PEO to cancel the terms of the contract?

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