

# **PEOs and Payrolling:**

A History of Problems  
and a Future without Benefits

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**The Center for a Changing Workforce**

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# THE CENTER FOR A CHANGING WORKFORCE

## About the Center

**The Center for a Changing Workforce** is a Seattle-based non-partisan, non-profit organization conducting research, education and policy development on issues affecting non-standard workers.

**The Center** is a member of the National Alliance for Fair Employment (NAFFE). For more information, visit the NAFFE website, *[www.fairjobs.org](http://www.fairjobs.org)*.

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## Executive Summary

- *Professional Employer Organization (PEO)* is another label for the staffing industry firms in the practice of “payrolling.” With payrolling, a real employer places regular employees on the “payroll” of a staffing firm, then claims these employees are not eligible for the company’s health and retirement benefits because they are claimed to be employees of the staffing firm.
- PEO revenues have climbed 520 percent since 1993 and they are the fastest growing segment of the staffing industry. With an annual growth rate of 25 percent per year, its revenues have jumped from an estimated \$6.5 billion in 1993 to an expected \$33.8 billion in 2000.
- While PEOs claim to provide “Fortune 500 level benefits” to workers on their payrolls, **in fact** evidence suggests that virtually **none** of the workers payrolled through PEOs are provided with employer-paid health or retirement plans.
- While not providing basic benefits, PEOs are prospering in the business of selling optional “supplemental” insurance to “captive” employees they payroll for employers. This practice raises questions of conflict of interest under federal benefit plan laws, in light of the PEOs’ fiduciary responsibilities as benefit plan administrators.
- According to industry sources, PEOs have made health insurance a profit center by discriminating against employees with pre-existing conditions. This is a clear violation of the Health Insurance Portability and Accountability Act (HIPAA).
- PEOs have engaged in a number of questionable practices as resellers of workers’ compensation insurance to employers in many states. These practices have included manipulating rates and opening fictitious companies.
- In August 2001, PEO groups introduced legislation in Congress to expand the employee leasing business and to enable PEOs to function as though they are true employers under federal tax codes. This proposed legislation provides an opportunity for a closer look at PEO practices.

## This Report Recommends...

- **Federal regulators** should investigate 1) whether PEOs are being used by employers to deny benefits to employees who would otherwise be in an employer's benefit plans; 2) whether PEOs have violated HIPAA; and 3) whether PEOs have violated federal laws by selling insurance to captive employees.
- **The Internal Revenue Service** should release the results of its *PEO Market Segment Study Group* report determining whether PEOs are violating federal tax and pension laws that allow only legitimate employers to offer benefit plans.
- **State insurance commissioners and legislators** should investigate PEOs' sales of voluntary supplemental insurance policies to captive workers, and determine whether PEOs, as multiple employer health plans, and the real employers have violated state insurance laws by discriminating against workers with pre-existing conditions.

## Introduction

Within the last decade there has been an explosion in the number of “nonstandard” or so-called “contingent” workers, according to the Bureau of Labor Statistics. BLS says these workers now make up 30 percent of the workforce. “Nonstandard” work includes:

- Temporary workers hired on a short-term basis;
- Independent contractors or freelancers who are self-employed;
- Part time workers;
- Misclassified workers—long-term employees who are mislabeled by their real employer as “temps,” “leased workers,” “contractors,” and many other labels; also known as “permatemps.”

## Staffing Definitions

The “staffing” business evolved from several discrete types of businesses. Many of these businesses and sectors have merged together, and many staffing firms offer overlapping versions of the same “services.” Here are some definitions and labels used in this fast growing industry:

- **Temporary Help** - providing temporary workers to meet the short-term needs of employers, including “day labor” firms providing blue-collar labor to employers.
- **Payrolling** - when an employer places some of its regular employees on the “payroll” of a staffing firm. The employer then claims these employees are employed by the staffing firm, and are thereby not eligible for the real employer’s health and retirement benefits.
- **Employee leasing** - another name for “payrolling,” in which the leasing company claims to be the employer of the “leased” employees.

These leased employees are also sometimes called “contractors” or “contract workers.”

- **Professional Employer Organization (PEO)** - a more recent name for employee leasing and payrolling, in which the PEO usually claims to be the “co-employer” along with the real employer.
- **Contract staffing** – another form of payrolling where the contract service company payrolls workers for companies usually in a specific industry—automotive, aerospace, energy, etc.
- **Staffing Firm** - another name for a payrolling agency, a temporary help agency, or an employee leasing company.

**Permatemps:** long-term employees who are mislabeled by their real employer and called “temporary,” “contract,” or “leased” workers. Permatemps do the same work as their co-workers who are called “regular” employees, though they receive less pay, fewer benefits and lack job security.

## Who is the Employer?

Regardless of what label is used, an important question to ask is *who is the employer?* For over 100 years, courts have been applying an objective test to determine the employer. Under this test (*common law of agency*), a worker is an employee of the firm that exercises control over the work.<sup>1</sup>

<sup>1</sup> See the following: *Community for Creative Non-Violence v. Reid*, 490 U.S. 736, 751-52 (1989); *Nationwide Mutual Ins. Co. v. Darden*, 503 U.S. 318, 322-23 (1992); *Professional and Executive Leasing, Inc. v. CIR*, 862 F.2d 751, 753-54 (9th Cir. 1988); *Daughtrey v. Honeywell, Inc.*, 3 F.3d 1484, 1492-93 (11th Cir. 1993); Rev. Ruling 87-41, 1987-1 Cum. Bul. 296, 298-99; *U.S. v. Garami*, 184 BR 834, 837-38 (M.D. Fla. 1995).

The common law test also looks at the job length, job location, whether the work is ongoing or temporary, and other factors.<sup>2</sup> The IRS uses the common law test to determine liability for payroll taxes, and the common law is a key factor in determining benefits eligibility.<sup>3</sup>

Under the common law test, the *objective facts* of the employment situation determine who the real employer is, not the *labels* and the *forms* the employers use to correspond to the label. For instance, in an October 2001 decision, the California Court of Appeal agreed with a lower court that a major employer, the **Metropolitan Water District of Southern California (MWD)**, is the real employer of a large group of long-term workers, even though MWD labeled them as temporary employees of staffing firms:<sup>4</sup>

**MWD determined the salary and benefits the worker would be paid, and decided how long the worker remained at MWD. MWD determined what jobs the worker did, where he worked, his hours, supervised his performance, decided whether he received a raise, how much the raise would be, and paid the provider [payrolling agency]... essentially as a payroll service for each worker under detailed contracts with the provider.**

**While MWD claims the providers “hired” the workers, they use that term only in the technical sense that MWD told each worker whether he would be ‘hired’ by MWD or a particular provider. Indeed, MWD sometimes transferred workers from one provider to another. Undoubtedly, MWD “employed” the workers under the common law control test. Likewise, the providers did not “employ” the workers under that test, but acted as a payroll service for MWD.**

While the staffing business uses many labels, there is only one distinction that matters—is the arrangement real **temporary work** or is it **payrolling**?

- With real **“temp”** work, the employee moves from one short assignment to another at *different* employers, as assigned by the agency. In contrast, many workers labeled as **“temps”** have worked for years in the same job doing the same work as their colleagues at the next desk. Similarly many workers labeled as **“contractors”** bear no resemblance to real independent contractors.

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<sup>2</sup> Congress has determined broader tests for some employment issues, including wage and hour violations.

<sup>3</sup> Watson, S. Derrin, “Who’s the Employer?” Watson, 1998.

<sup>4</sup> *Metropolitan Water District of Southern California v. Superior Court of Los Angeles County*, 2001 WL1230457 (Cal. App. 2d Dist. 2001).

- With payrolling, the PEO or staffing firm *claims* to be the employer because the worker is on its payroll, yet the employee is under the supervision and control of the real worksite employer, often for many years. In payrolling, the employees are usually mislabeled or misclassified as “temps” or “contractors” as part of the scheme.
- The courts define “payrolling” as providing administrative or financial services for employers, rather than serving as an employer in the sense of hiring or supervising workers. According to an Ohio Appeals Court decision: “*Payrolling is a term which means one company funds the payroll of another company’s employees and then bills the company for reimbursement.*”<sup>5</sup>

No matter what the label, the employee leasing and payrolling business represents a dangerous permutation of two of the past decade’s top business trends: the flexible workforce and the outsourcing of human resources. **It is a trend with enormous implications for American workers and taxpayers.**

## The History of Employee Leasing

Modern employee leasing began in the 1960’s as physicians and other professionals discovered they could create more generous tax-sheltered retirement accounts for themselves by using leasing companies to create the illusion that the physicians were employees of a different company than their lesser-paid non-physician employees.

In the 1970’s and 80’s the IRS questioned the legality of employee leasing deals that were obviously only tax shelters for professional owners. In an early case, a Kansas City PEO, **Staff Employees**, was found to have violated the tax law by payrolling employees for a group of doctors (*Burnetta v CIR*).<sup>6</sup> The doctors used the payrolling scheme in an attempt to exclude their employees from their tax-qualified profit-sharing pension plans. According to the court:

**In operation, Staff was essentially a company that provided payroll services for its clients. Its slogan was, ‘regular employees for your work on our payroll’... [A Staff promotional letter read] *Wouldn’t it be nice if you could have your own employees, without the burden of payroll? Well, you can! With our service your employees become our employees.***

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<sup>5</sup> *Snelling and Snelling v. ARICO* 83 Ohio App.3d 89, 613 N.E.2d 1107 (1993), See also *Gulf Insurance v. GFA*, 2001 WL 1046160, \*1 (Ga. App.), where the Court found a PEO’s “role was limited to providing payroll services... and workers compensation insurance.”

<sup>6</sup> *Burnetta v. CIR*, 68 U.S. Tax Court Reports 387 (1977).



The tax court found that despite contracts claiming the workers were employees of the leasing company, the facts demonstrated that the doctors were the real employers:

**There is no indication that Staff maintained any control over, or conducted any supervision of the employees in the performance of their duties in the doctors' offices...We see this merely as a payroll service operation and lacking the substance necessary to create a common law employer-employee relationship.**

In a reverse twist on *Burnetta*, **Professional & Executive Leasing (PEL)**, an Idaho PEO, was found to have violated pension laws by placing doctors and other professionals on the leasing company payroll with generous benefits, while the doctors' employees were left with inferior plans.<sup>7</sup> PEL claimed that the professionals were its employees based on written contracts, but the Court decided that PEL could not claim them as employees since PEL was only a payrolling agency with no control over professionals who ran their own businesses:

**PEL's control over the workers was not sufficient to establish an employment relationship...the finding that [PEL] exercised minimal, if any, control over the workers is supported by the evidence. The contracts PEL entered into appear to give PEL control over its workers. The right to control was at best, illusory.**

This concept expanded in the 1980's with the creation of tax shelter "safe harbors" in the federal tax code. In late 1980's and early 1990's numerous leasing companies went bankrupt or were forced out of business in cases of fraud, including payroll fraud and the mishandling of employees' retirement funds. To escape this bad image, in 1994, the National Staff Leasing Association (NSLA) changed its name to National Association of Professional Employer Organizations (NAPEO) and began promoting the PEO concept.

## How PEOs Work

Like other staffing firms, PEOs promote themselves as a way for employers to cut costs, keep a trained workforce and avoid the hassles of being an employer. PEOs assert that while employers save money and become more profitable, workers are happy with the results. When employees "become" leased workers, the company tells these employees they are "leased" from the PEO, and their paycheck and benefits will come from the PEO, though their work will be overseen by their regular supervisor.

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<sup>7</sup> *Professional and Executive Leasing, Inc. v. CIR*, 862 F.2d 751, 753-54 (9th Cir. 1988).

The workers' only contact with that PEO will be faxing their timesheet in before payday. They will naturally be confused about whom to contact if there are workplace safety, discrimination or other workplace problems. Some or all of their co-workers may also "become" "leased" workers.

According to their sales materials, the PEO and the employer divide up or share employer responsibilities by contract, an arrangement they sometimes call **co-employment**. In this arrangement, the PEO claims to be the "co-employer" along with the real employer. The PEO claims responsibility for the "business of employment" such as human resources, and payroll & employee taxes. This is slightly different from other variations on employee leasing where the staffing firm claims to be the sole employer. However, "co-employment" relationships of this nature are legally recognized by only a few states, and are not recognized in federal law.

The California Court of Appeal recently rejected the argument of an employer who excluded some of its employees from a pension plan because they were hired and paid through staffing firms through a "co-employment" relationship.

**Even if (there were) a co-employment exception to this common law definition of employee, that exception would assume the workers were 'employed' in some meaningful sense by the providers (payrolling agencies). Because they were not [the issue is not relevant]...<sup>8</sup>**

Some PEOs also offer additional services to the real employer, such as human resource consulting, insurance services and 401(k) plans to employers who are willing to pay extra. As this report explains in the following pages, few employees are covered by these plans. Many staffing firms and PEOs offer both payrolling services and other services—in fact a number of PEOs *are* divisions or subsidiaries of large staffing firms such as **Kelly Services**, and most large staffing firms, including **Adecco** and **Manpower**, offer PEO or payrolling services.

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#### **Their Jaws Drop When I Tell them...**

*Richard Bailey has been working for Okaloosa County, Florida, for seven years as a computer specialist. For the first two years the County labeled him a "temp," without benefits, then, five years ago, he was placed on the payroll of Kelly Services which "payrolled" him for the County and he continued to work without the benefits received by regular employers.*

**"Everyone here, from the Tourist Office to Engineering, thinks we are regular employees," says Bailey, "and their jaws just drop when I tell them how the County uses Kelly to payroll us."**

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<sup>8</sup> *Metropolitan Water District, supra.*

**Kelly**, for example, offers payrolling in several forms—a “Staff Leasing” division and a “Payroll Services” division, providing essentially the same service with different labels. For example, **Kelly** offers a solution to the “problem” of what to do with *“a group of your current or former employees that you choose not to have on your payroll. The solution? Put them on our payroll.”*<sup>9</sup>

## The Size and Scope of the PEO/Payrolling Business

Business and government agencies count PEOs and employee leasing as one category because there is little difference between the two—this report does the same.

There are few independent estimates of the number of workers payrolled by PEOs. One source is the Economic Census data gathered by the Census Bureau, which estimated 900,000 PEO-payrolled employees in 1997. The Bureau of Labor Statistics (BLS) Contingent Work Survey attempted to determine the number of leased workers in 1995, but discarded the survey results as inaccurate,<sup>10</sup> while other BLS staff have estimated the number at 2.5 million.<sup>11</sup>

There are a number of business estimates of PEO payrolled employees; however most of the data are self-reported. These estimates range from 900,000 to 3 million workers (*see Appendix I*). Any measurement of the number of workers “payrolled” through staffing firms must also count payrolling done by “temp” firms, “contract” companies and other sources. CFCW estimates that nearly a million additional workers (908,000) were payrolled by other staffing firms in the “temporary” and “contract” employment categories in 1997(*see Appendix V*). This does not count a large amount of payrolling done by firms outside the staffing industry. For example, firms that payroll workers for oil companies are known as *oil and gas field service firms*, and workers on their payrolls are counted as oil industry workers.<sup>12</sup>

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<sup>9</sup> Kelly Services website, [www.kellyservices.com](http://www.kellyservices.com)

<sup>10</sup> The BLS concluded that workers were confused by the term ‘leased employee.’ Some workers surveyed reported that they were leased employees because they worked for Avis Car Rentals.

<sup>11</sup> Estimate in material presented by Webster Graham, BLS ES-202 Conference, June 1996.

<sup>12</sup> See the description of oil industry payrolling in *Casey v. ARCO*, Case N. 99-06437 LGB.

Even without these additional workers, our estimate of the number of payrolled employees in 1997 (1.8 million) matches or exceeds that of real temp workers, yet the practice of payrolling is virtually unseen.<sup>13</sup> The average pay for PEO-payrolled employees was \$21,469 in 1997, according to the Economic Census, close to the NAPEO estimate of \$22,517.<sup>14</sup>

### **PEOs: Payrolling Services are Big Business**

The 1990s were profitable years for the PEO business as PEOs expanded rapidly and went public on Wall Street through IPOs. Since 1993 PEO revenues have escalated 520 percent, from an estimated \$6.5 billion to an estimated \$37.5 billion in 2000 (an annual growth rate of 25 percent per year), and is expected to grow to \$45.4 billion in 2002. The top states for PEOs, as measured by sales, are shown in Table 1 and *Appendix IV*.

The PEO business has about 27% of the US staffing market, according to staffing trade publication figures.<sup>15</sup> By comparison, the temporary help business (which also includes some payrolling services) has estimated revenues of \$85.9 billion in 2000, and about 61% of the staffing market. According to the Staffing Industry Report, the top five PEOs in 2000 were Administaff, Inc., Staff Leasing, Inc., ADP TotalSource, HR Logic, Inc., and Epix Holdings Corp.<sup>16</sup> Estimates of the number of PEOs operating in the U.S. range from 917 to 3,919.<sup>17</sup>

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Table 1. Top 15 States for PEOs

State	Receipts (\$1,000s)	Number of Employees
Florida	4,497,512	199,646
Texas	3,398,424	106,126
California	1,991,195	68,456
Illinois	1,508,732	39,870
Michigan	1,396,966	40,063
Georgia	1,282,125	64,544
Arizona	1,056,329	55,618
Ohio	672,935	22,565
New York	640,796	25,436
Utah	554,682	19,438
New Jersey	548,373	13,726
Indiana	539,308	15,767
Tennessee	481,435	15,444
South Carolina	467,773	19,646
Alabama	363,952	14,780

Source: 1997 Economic Census

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<sup>13</sup> The 1999 BLS Contingent Work Survey indicated 720,000 workers paid by temp agencies on short-term assignments. Our analysis of the 1997 Economic Census data estimates 1.8 million temp agency workers on temporary assignments.

<sup>14</sup> NAPEO 2000 Financial Ratio Survey

<sup>15</sup> Staffing Industry Analysts, Staffing Industry Sourcebook, 2000-2001, based on 1997 Economic Census.

<sup>16</sup> Staffing Industry Analysts, Staffing Industry Report, June 26, 2001

<sup>17</sup> Aaron, Carrie, PEO Census 2000, www.peonetwork.com, US Dept. of Commerce, 1997 Economic Census.

The top industries using PEOs are shown in Table 2 (*see Appendix II*), and include transportation, manufacturing and construction. These are industries with high workers' compensation costs. The PEO business asserts their average client employer payrolls 15 employees through PEOs.

While PEOs say their focus is on small businesses, today they payroll workers for large employers, just like other staffing firms. For example, **Staffing Concepts International**, a Georgia-based PEO, claims a customer with 6,500 employees. **ProLease**, a Maryland PEO, recently won the exclusive franchise for payrolling for Pizza Hut, Taco Bell and KFC franchises, a potential market of 1.2 million employees alone.<sup>18</sup>

Large staffing firms such as **Kelly** also provide payrolling services for many large employers, including AOL/Time-Warner, Microsoft, Hewlett-Packard, Cisco, BP, Ford, Johnson & Johnson, Merrill Lynch, Disney, and Coca-Cola to name a few. On the public side, many larger government agencies down to small local governments use payrolling to reduce the apparent size of their "official" payrolls.

## **PEOs – Where are the benefits?**

The PEOs paint a rosy picture of their employee benefits. For example, Milan Yager, Executive Vice-President of NAEPO, says PEOs provide their employees with "Fortune 500 quality" benefits, including health insurance and 401(k) savings plans.<sup>19</sup>

However, upon closer examination, it becomes clear that the PEOs' promotional statistics are not accurate. NAEPO says 98 percent of their member PEOs offer health care plans, but what NAEPO does not reveal is the number of employees who do not have a plan offered to them. They also leave out how many employees must pay *100 percent* of the cost of their health plan.<sup>20</sup> NAEPO boasts that 90 percent of PEOs have a 401(k) plan, but they do not say how many client employers using PEOs actually offer a 401(k) to their employees, nor do they say how many of these employers actually *contribute* to the employee's 401(k) plan.

Table 2.

### **Top Industries Using Leased Employees**

Industry	Number of Employees
Transportation	134,760
Manufacturing	104,415
Construction	102,123
Other Industries	92,716
Accommodations	77,311
Health and social services	58,363
Retail trade	57,236
Adminis. and support services	48,304
Prof., scientific, tech. services	47,987
Repair services	38,016

Source: 1997 Economic Census - March 2001

<sup>18</sup> ProEmp Journal, Sept. 10, 2001

<sup>19</sup> Yager, Milan, (NAEPO) Statement to Adv. Council on Employee Welfare and Pension Benefit Plans, DOL 7/99

<sup>20</sup> Yager, Milan, *supra*.

## Most PEOs Provide No Benefits

According to Carrie Aaron, president of a major PEO consulting firm (PEO Network, Inc.), reality is the opposite of NAPEO's claims. In an article entitled The Blueprints for Start-up PEOs, Aaron breaks the PEO business into three categories based on what benefits employees are provided. Aaron estimates that almost *two-thirds* (65 percent) of PEO-payrolled employees are covered by the category that includes payrolling-only services (Category I), with *no* health insurance or retirement plan.<sup>21</sup> Workers in the second category, an additional *one-third* (30 percent) of PEO-payrolled employees, receive *no* retirement plan and only "optional," *100 percent employee-paid* health insurance. Finally, only *1 in 20* PEO-payrolled employees (5 percent) receive normal benefits in a Category III "full-service" PEO.

The Blueprints for Startup PEOs		
<p>Category I 65% of PEO-Payrolled Employees</p> <p>The PEOs in this category basically provide payrolling services, which the temporary staffing industry has been providing for many years...Payrolling is defined as providing <i>payroll, payroll tax administration, and workers' compensation</i> to clients. ...65 percent of worksite employees are delivered this level of service..."</p>	<p>Category II 30% of PEO-Payrolled employees</p> <p>The majority of PEOs could be classified in the Category II range...PEO Network estimates 30 percent of the worksite employees receive services delivered in this range. Services are the same as in Category I, plus <i>optional health insurance</i>, reactive loss control and very basic HR services.</p>	<p>Category III 5% of PEO-Payrolled Employees</p> <p>A full service PEO... provides (services of Category II plus) mandatory employee benefits, ancillary employee benefits, preventive risk management, quality loss control and a full-service HR department.</p> <p style="text-align: right;"><i>Source: PEO Network Inc.</i></p>

This "Blueprint," written by an executive with 15 years of industry experience, confirms that 95 percent of all PEO-payrolled employees are offered *no* retirement and *only employee-paid* health insurance by PEOs.

## PEO Payroll "Markups"

According to the 1997 Economic Census, PEOs national gross revenue was \$24.1 billion, and their payrolls totaled \$19.2 billion, leaving a gross margin or "markup" of \$4.9 billion. This markup of 25.5 percent of payroll includes all employee benefits *and* PEO overhead costs. A sample of seven large (and presumably more efficient) PEOs indicates overhead costs average 10 percent of payroll.<sup>22</sup> After subtracting this overhead, plus typical 11.9 percent payroll taxes, major PEOs are left with less than 4 percent of payroll for benefits. (Figure 1.)

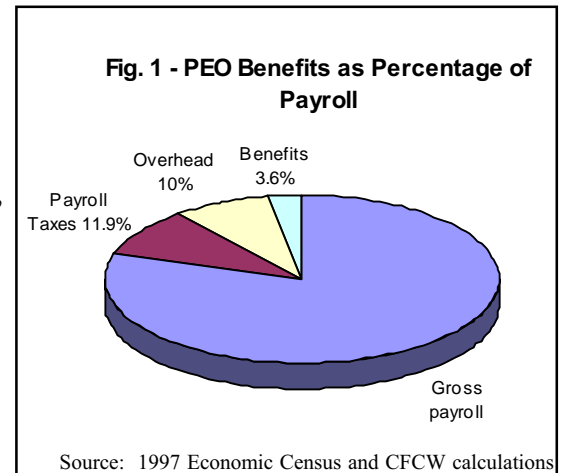
<sup>21</sup> Aaron, Carrie, "Blueprint for Start-up PEO," The ProEmp Journal, August, 1998.

<sup>22</sup> The firms surveyed were Barrett Business Systems, Employee Solutions, Outsource Intl., Team America/Team Mucho, SOS Staffing Services, Staff Leasing, and Administaff, for the years 1996-98, based on SGA costs reported on SEC 10-k reports.

The average cost of what most employees would consider employer benefits—retirement, insurance, paid vacation, holiday and sick leave—plus legally required payroll taxes, is **33 percent** of payroll (see *Appendix III*). *It would be impossible for most PEOs to provide acceptable employee benefits with their average margins, even without overhead costs!*

### **Real PEO Employees Get Real Benefits**

While PEOs provide few benefits to payrolled employees, their *real* employees get excellent benefits. These employees sell PEO services to employers and process the payroll at the PEO headquarters and branch offices. For example, **ADP Employer Services** offers its real employees a discounted stock purchase plan, health, dental and vision coverage, a pension *and* a 401(k) plan, life and disability insurance, paid vacation, sick and holidays, tuition reimbursement, and on-site child care among other benefits.<sup>23</sup> The industry-supported legislation currently before Congress (see page 28) clarifies that benefit plans established for *worksite (payrolled)* employees are separate from benefit plans covering *real* PEO employees.<sup>24</sup>



### **Health Insurance: The PEO Two-Tier System**

In order to cut costs, employers seek to minimize the numbers of employees who are eligible for benefits. They are partially constrained by insurance industry underwriting rules and employee morale issues. By placing some employees on a PEO payroll, employers avoid insurance *minimum participation* rules that often require employers to have all or most workers on one health plan. For example, Premera Blue Cross and Regence Blue Shield, the largest health insurance carriers in the Northwest, both require 75 percent of eligible employees to be covered under employer plans, and require the employer to pay 75-80 percent of the cost of the insurance.<sup>25</sup> While employers can exclude “classes” of employees (such as production workers), from participating in the employer’s group insurance plan, this causes employee morale problems, as it has been customary for major employers to provide health and retirement benefits to all permanent full-time workers.

<sup>23</sup>www.adp.com

<sup>24</sup>H.R. 2807, GPO version, pg 5, lines 21-25, pg 6, lines 1-3, pg 17, lines 21-25, pg 18, lines 1-6.

<sup>25</sup> Small group (4-50 employees) health insurance contracts with Premera Blue Cross and Regence Blue Shield.

By payrolling lower-paid employees through PEOs which pose as the employer for payment of wages and benefits, employers can ‘wash their hands’ of the insurance responsibility, and tell employees that the benefits levels are set by the PEO, not by the real employer. PEOs thus sever the connection between the real employer and the employee benefits. This opens the door for a ‘two-tier’ benefits scheme, where highly paid employees receive premium health and disability plans at the real employer, while lower-paid workers on the PEO payroll have optional ‘bare-bones’ or no coverage. A RAND Corporation report cited PEO executives:

**Industry representatives cited examples where an employer decided not to “purchase” health insurance for some or all of the employees it leased. Some employers used leasing firms to avoid having to provide benefits to certain classes of employees. Low-wage workers...were among those typically excluded from the benefit.<sup>26</sup>**

PEOs often try to give the impression that *all* of a company’s workers, including executives, are placed on the PEO payroll and receive the same benefits and thus, there is no ‘two-tier’ benefits scheme. But in the real world, PEOs only provide the benefits that the employers direct them to provide to selected employees the employers direct them to payroll. Here are two examples:

**Thank you for choosing Payrolling.com, the leading provider of employee leasing and payrolling! As a PEO we are experts in payroll and human resources. Our job is to take the employees that you identify and place them on our payroll.<sup>27</sup>**

**Our core competency is cost-effective, efficient and reliable payrolling of your referrals [employees]... (*PayWise*)<sup>28</sup>**

Alternatively, the employer can move its executive staff “off” the employer payroll and onto a PEO payroll, leaving lower-paid workers on the regular payroll with a 100 percent employee-paid benefit plan. (For more details, see discussion of *Burnetta* and *Professional Executive Leasing* cases on pages 8-9.) There are limitless variations on these employer schemes.

Federal tax laws require that benefit plans be “non-discriminatory” to qualify for business tax deductions. The plans cannot be “top heavy” with benefits for “highly

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<sup>26</sup> Leibowitz, Arleen, et. al. “Multiple Employer Welfare Arrangements,” RAND Corporation, 1992, p. 26

<sup>27</sup> [www.payrolling.com](http://www.payrolling.com)

<sup>28</sup> [http://www.employerhealth.com/EHR\\_sample\\_pages/dpspeo.htm](http://www.employerhealth.com/EHR_sample_pages/dpspeo.htm)



compensated” executives while excluding less-favored employees. PEOs and other staffing firms help employers evade this law. For employers with less than 100 employees (including most PEO clients), “leased” employees are not counted when the employer calculates whether their health plans meet the normal requirement of covering at least 70 percent of their workers.<sup>29</sup>

## Discrimination Against Workers with Pre-Existing Conditions

Many PEOs offer to sell health insurance to individual payrolled employees, with the employees paying 100 percent of the cost. These insurance sales have become a PEO profit center, according to consultant Aaron:

**Most people have mistakenly thought that health insurance was never a profit center. I disagree. For a category II (medium) and category III (larger) PEO, it is the largest profit center available.**<sup>30</sup>

Aaron explains that PEOs who use strict “*medical underwriting*” will continue to grow and profit, while those who do not will lose market share. Medical underwriting is the practice of requiring prospective employees to fill out medical history forms detailing pre-existing health conditions or a family history of health problems. (*See Appendix VII for an example of a PEO medical history form.*) PEOs can then exclude from coverage any workers who are potential risks, or knowingly pass these high-risk workers on to outside insurers, while insuring the healthiest employees themselves. Many PEOs have excelled at this scheme, which goes against all the accepted principles of insurance underwriting, and creates an ongoing battle with insurers. According to one source:

**The brief period when the PEO industry looked promising to the health insurance carriers lasted only until the carriers realized that what many PEOs were delivering was very low employee participation, and very little employer contribution to premiums. Worse still was the fact that, of those participants delivered (to the insurers) by these PEOs, many were poor health risks, thereby creating (a pattern of huge health care expenses) that was to continuously haunt the carrier/PEO relationship.**<sup>31</sup>

“PEOs have battered the health care insurance industry with their (underwriting) practices,” says a prominent consultant.... “the overall situation has deteriorated to the point where it is very difficult to get both industries talking to one another.”<sup>32</sup> Some PEOs “self-insure” employees’

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<sup>29</sup> 26 USC Section 5000(b)(2)

<sup>30</sup> Aaron, Carrie, “PEO Profit Centers” The ProEmp Journal, December 2000

<sup>31</sup> Feinberg, Harry, “The Health Care Erosion,” ProEmp Journal, March 2000

<sup>32</sup> Feinberg, supra

health insurance, meaning the PEO takes on the risk of paying hospital and other health care bills of selected employees:

**These plans are considered particularly nefarious by health insurers because PEOs ... self-insure those participants who are in good health and usually pawn off those high-risk individuals to the insurance carriers.<sup>33</sup>**

It appears that the PEOs engaging in “medical underwriting” are clearly in violation of the *Health Insurance Portability and Accountability Act* (HIPAA). Under HIPAA, group health plans may not establish rules for individual eligibility based on health status, health condition, medical history or disability. These discriminatory practices may also violate state laws, since PEOs are covered under state insurance laws as multiple employer plans.<sup>34</sup> According to an official at the Department of Labor, staffing industry violations of HIPAA are a recognized problem.

### **Health Care Coverage: A Burden for the Worker**

The large majority of Americans with health insurance obtain their coverage through their employer. Indeed, employer-based insurance, which covers over 60 percent of Americans, has been the foundation of the U.S. health insurance system for half a century. Since the 1980s the proportion of private sector employees who are insured through their jobs has been declining. The share of U.S. workers under age 65 with health insurance through their own employer fell from two-thirds (66 percent) in 1979 to just over half (54 percent) in 1998.<sup>35</sup>

The basic problem with PEOs’ benefit plans is the direct financial burden they place on the worker. Employees must pay 100 percent of the cost with most PEO-sponsored insurance plans, which is beyond the financial means of most families today. The average cost of family coverage in 2000 was \$6,351 - almost 30 percent of the average PEO wage of \$21,469.<sup>36</sup> Recent research shows that when workers spend more than 15 percent of their income on health insurance, chances are less than 50 percent they will purchase health insurance.<sup>37</sup> Even if employees want insurance, paying the rent and buying

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<sup>33</sup> Feinberg, *supra*

<sup>34</sup> Since PEOs are not legally single employers, their plans are not exempt from state regulation under ERISA.

<sup>35</sup> Center for National Policy, “How the New Labor Market is Squeezing Workforce Health Benefits,” June 2001.

<sup>36</sup> Gabel, Jon, et. al. “Job-Based Health Insurance In 2000,” *Health Affairs*, Sept.-Oct. 2000

<sup>37</sup> Kronick, R. and Gilmer, T. “Explaining the Decline in Health Insurance Coverage, 1979-1995.” *Health Affairs* (March 1999).

groceries comes first—leaving their families to rely on charity care and tax-supported programs for their family health care.

There is a huge social cost to the PEOs' insurance practices. PEOs are a major contributor to the growing number of workers without health insurance in America by providing only “optional” insurance to most employees, and severing the connection between the real employer and health benefits. In addition, discriminating against workers with pre-existing health conditions adds to the crisis of the uninsured, and unfairly burdens other employers and taxpayers when hospitals raise rates to cover charity care for the uninsured workers.

The claim that PEOs help small business employers offer better insurance is also hollow. Over 30 percent of small businesses provide insurance, far above PEO coverage levels. Finally, to add insult to injury, most PEOs/payrolling companies offer little or no paid sick leave, holidays or vacation, resulting in workers not only facing health expenses that could bankrupt them, but loss of pay for sick days missing from work.

### **Selling Supplemental Insurance to “Captive” Workers**

In recent years, PEOs have become a major sales channel for what is known as “**voluntary supplemental insurance**”(VSI). W. Clement Stone, who made a fortune selling insurance using Dale Carnegie-style “*Think and Grow Rich*” motivational sales methods, popularized VSI with his **Combined Insurance Company**. VSI products include cancer and intensive care insurance. The policies promise to pay enrollees a fixed amount (\$30 per day, for example), during hospitalization. **American Family Life Assurance Company (AFLAC)**, the largest VSI insurer and the sixth largest publicly traded insurer, is well known to television viewers with its AFLAC “duck” ads. Is VSI a good deal for consumers? Not according to Consumer Federation of America insurance expert Robert Hunter:

**Every analysis has shown that supplemental insurance is a waste of money for consumers—it's like buying toothpaste a squeeze at a time. Each policy only covers a small amount of the total risk that an individual faces. Consumers are much better off with regular health and disability insurance. As for their claim that “no insurance is complete without it,” the best advice is: never buy insurance from a “quack.”**

Hunter adds, “I have a real fear that some consumers are buying VSI *instead* of regular insurance because it’s cheaper, which is very dangerous.” Inconclusive evidence suggests that this may be happening—according to data from the 1996 Medical Expenditure Panel Survey (MEPS), none of the respondents with VSI had regular insurance, but the sample was too small to be significant.

VSI is far more profitable for insurers and for sales agents than regular group insurance. For the insurer, VSI policies typically pay out only 50 percent of premiums back to enrollees in claims paid out, compared to regular insurance policies where insurers pay out more than 80 percent of premiums in claims. For the insurance agent, VSI policies offer 25-35 percent first year sales commissions, while regular group insurance policies offer only 10 percent sales commissions.<sup>38</sup>

Insurance agents, with the approval of the employer, sell these products directly to workers, at their workplace. Since the PEOs have a captive audience of worksite employees, they are ideal sales channels for VSI. PEO sales of VSI are an excellent example of “creating your own market,” since the regular health insurance sold by PEOs are usually ‘bare-bones’ plans with large out-of-pocket costs, thus creating a “need” —that workers should buy VSI to attempt to fill the holes. Insurance broker Bruce Leon puts it this way to PEO owners:

**According to a new KMPG Peat Marwick survey, employees are being asked to shoulder a greater percentage of health care costs, while benefits are simultaneously eroding. That is why PEOs ... view voluntary products as a way to meet their clients’ needs...and of course provide additional income stream... Over 70 percent of employees purchase insurance through their place of employment... and voluntary insurance can be a substantial profit center (for PEOs).<sup>39</sup>**

Licensed insurance brokers operate some PEOs, allowing them to sell VSI directly to captive employees and capture the entire sales commission. Broker Leon recommends that PEOs hold employee “seminars” where the products can be introduced to employees, without the help of outside sales agents so the commissions do not have to be shared.<sup>40</sup>

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<sup>38</sup> For example, Colonial Penn “Cancer Response Plus” policy - 32.5 percent first year premium, Colonial Penn Group Plan, 8 percent first year premium.

<sup>39</sup> Leon, Bruce, “Supporting Critical Illnesses,” *The ProEmp Journal*, January 2001

<sup>40</sup> Leon, Bruce, “Voluntary Viabilities,” *The ProEmp Journal*, November 2000

## A Breach of Fiduciary Duty?

PEO executives who sell VSI to captive payrolled employees have a significant conflict of interest, which violates their fiduciary duties under ERISA.

These employers are entrusted with protecting their employees under the law. Under the Internal Revenue Code and Title I of the Employee Retirement Income Security Act (ERISA), it is a prohibited transaction to have:

**A fiduciary (trustee of a benefit plan) acting in any capacity in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan or of its participants or beneficiaries.<sup>41</sup>**

Fiduciaries must perform their duties solely in the interest of participants and beneficiaries—in this case the worksite employees payrolled by the PEO. In this case PEO owners are also health benefit plan administrators and make all plan decisions affecting employees.<sup>42</sup> In addition, a fiduciary is charged with using the diligence that a prudent person who is familiar with such matters would use, a standard that is called the *prudent expert rule*. The situation parallels that of ‘gatekeeper’ doctors in many HMO plans who individually may profit by not referring patients to specialists or by avoiding patient hospitalization.

Employers like VSI because it creates employee options without cost to the employer. The insurance industry has recognized this in their sales pitches:

**Work Site Marketing ...The wave of the future. It’s predicted that the great majority of all insurance products will be available at the workplace - policies “endorsed” by the employer but paid for by the employee... These supplemental insurance plans... reduce the pressure on company-paid options.<sup>43</sup>**

**Some of the advantages AON Worksite Solutions, brings to PEO’s include... Offering employee benefits while keeping costs low and growing profits at the same time.<sup>44</sup>**

## Insurers See an Opportunity—Using Subsidiary PEOs to Sell their Products

The VSI insurers see PEOs as direct sales channels for their own products. AFLAC recently joined several other financial giants in purchasing HR Logic, the fourth largest PEO, and HR Logic sells AFLAC insurance to its captive employees.<sup>45</sup> AFLAC also made earlier

<sup>41</sup> ERISA § 406(b)(2), 29 USCA § 1106(b)(2).

<sup>42</sup> CFCW examined the health benefit plan tax reports for 27 PEOs for the years 1991-98. For 19 PEOs, the health plan administrator was also the employer, and in 6 other plans, the relationship was unclear. Only in two PEOs were the plan administrators not also the PEO owners/executives.

<sup>43</sup> www.AFLAC.com

<sup>44</sup> www.aonworksitesolutions.com

<sup>45</sup> Staffing Industry Report, March 2000

investments in NovaCare Employee Services and Peopleworks, a major southern PEO. CNA brokers offer employers a CNA PEO service that sells CNA VSI to its payrolled employees. Two other major PEOs, Epix Holdings and Selective HR Solutions, are also owned by insurance companies. This raises a legitimate policy issue as to whether insurers should be allowed to hold major ownership shares in PEOs, given the potential for abusive sales practices.

VSI has a history of consumer abuses. In 1996, for example, Combined Insurance settled out of court for insurance fraud with 63 policyholders for \$8.25 million. The settlement is four-and-a-half times Combined's profits from 1985-94 in the State of Alabama. Combined's misconduct included misrepresentation, fraudulently suppressing key information from policyholders, negligent training and supervision of agents; and illegal conversion of policyholder funds. AFLAC also faces current lawsuits from policyholders in Alabama, California and other states, including a complaint filed against AFLAC and the California Professional Employers, Inc. (CPE), alleging CPE collected AFLAC premiums from an employee, but AFLAC did not provide insurance for the employee.

## **PEO Retirement Plans: Employees Do All the Work**

Employer-provided retirement benefits are a key element in the retirement plans of American workers. In 1999, firms sponsoring pension plans employed 58 percent of all private wage and salary workers. Almost two-thirds of full-time workers (64 percent) and 37 percent of part-time workers worked in firms with retirement plans.<sup>46</sup> Even among smaller employers, 46 percent of employees participate in a retirement plan. Of the employers with typical 401(k) plans, 79 percent offered matching contributions, with 67 percent matching 50 percent or more of the employee contribution.

## **Tax Returns Show Less Than 10 Percent of Employees Get Benefits**

This study analyzed a sample of 78 *Annual Returns/Reports of Employee Benefit Plans—IRS Form 5500s*, filed by 14 major PEO firms during the years 1991-98, covering 1.6 million employee-years.<sup>47</sup> This task was made more difficult by the failure of many PEOs to provide complete information on the Form 5500s—many companies did not list key data, including the number of employees, the number of employees excluded from plans, or even whether employers or employees made contributions.

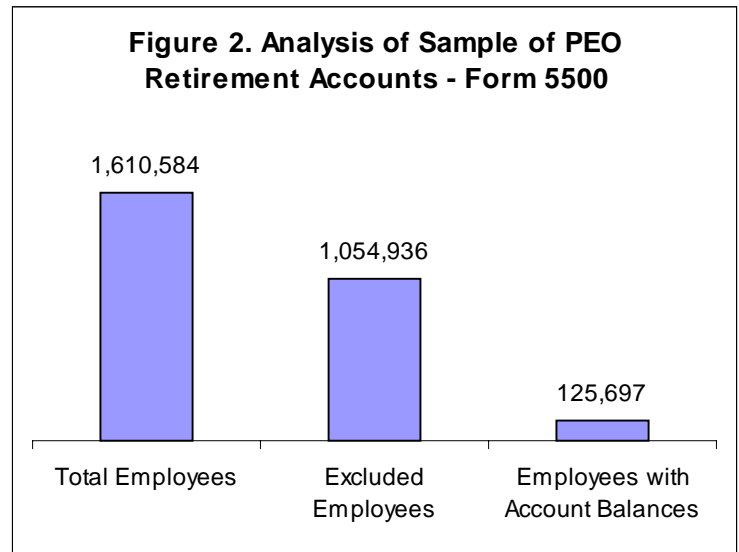
<sup>46</sup> Contingent Work Supplement to the February, 1999 Current Population Survey, BLS.

<sup>47</sup> The sample included Kelly Staff Leasing, Barrett Business Systems, Employee Solutions, Outsourcing International, Team America /Team Mucho, SOS Staffing Services, Strategic Outsourcing, and Administaff.

These omissions are contrary to federal requirements. There were also major discrepancies between the number of employees reported on the Form 5500 and on the SEC annual '10k' reports. Some patterns, however, were clear. A number of large PEOs showed a pattern of *zero* employer contributions to 401 (k) plans including:<sup>48</sup>

- **Kelly Staff Leasing - 1994-1998**
- **Employee Solutions - 1994-1997**
- **Team America - 1993 - 1998**
- **Sunshine Staff Leasing - 1994 - 1998**

The real worker participation rate is less than 10 percent for PEO retirement plans (**Figure 2**). Only 125,697 (7.8 percent) PEO-payrolled employees had money in retirement accounts in the years surveyed. The PEOs in the sample claimed that 65 percent of the employees were excludable under the federal tax laws.<sup>49</sup> Even after the exclusions, less than a quarter (22.6 percent) of the remaining employees had account balances. Four out of every five dollars in retirement contributions (80 %) came from employees.



The PEOs' own websites provide evidence how the real employer is really in charge when it comes to PEO retirement benefits:

- **The company intends to match up to 2% dollar for dollar of your earnings... to a maximum of \$1,000... You should be aware that employees assigned to the 'client' companies who have declined coverage under the Plan... are not eligible to participate in the Plan. (Strategic Outsourcing)<sup>50</sup>**
- **The 401(k) Retirement Plan may be adopted by each client that desires to offer this benefit to their employees. (Elite Employer Services)<sup>51</sup>**

<sup>48</sup> Another large PEO, Epix, claimed \$22 million in employer contributions and zero employee contributions. This is almost certainly misreporting—most likely the reverse was true.

<sup>49</sup> The federal tax code allows plans to exclude employees not meeting minimum age and service requirements, nonresident aliens with no US earned income, and collectively bargained workers.

<sup>50</sup> Strategic Outsourcing International website ([www.soi.net](http://www.soi.net)).

<sup>51</sup> Elite Employer Services ([www.eliteemployer.com](http://www.eliteemployer.com)).

- **Should your company *choose* to participate in our 401(k) program, your employees can take advantage of a cash deferment retirement plan. They can select ...funds in which to invest their money. (Creative Staffing Systems-emphasis added)**<sup>52</sup>
- **Human Resource support services...and a 401(k) plan where the employer is not required to participate whatsoever. (Sunshine Companies)**<sup>53</sup>

## Retirement Policy Implications

The review of staffing industry journals, Economic Census data and 5500 Returns all lead to a second conclusion—PEO-payrolled workers, *who are not temporary workers*, are rarely provided retirement benefits. This takes on critical importance as Congress debates the future of the Social Security program. With discussions about cutting future benefits, raising the retirement age, and even raiding Social Security to pay for other programs, there is less certainty than ever about the future of retirement benefits. Many employees depend on private employer retirement plans for their core retirement benefits, with Social Security and savings helping to supplement the private benefits. While the average employer retirement contribution—fifty-seven cents per hour—seems small, without this benefit, the average worker faces a retirement in poverty. According to the EBRI Databook on Employee Benefits<sup>54</sup>:

- **Nearly one half of all benefit payments to individuals are retirement benefits, and more than half—\$313 billion in 1994—come from employer retirement plans.**
- **For retirees over age 65, a private pension is second only to Social Security in importance.**
- **In 1994, these benefits averaged \$13,363 for public employees, \$6,075 for private pensions.**

For employees who use the PEO 401(k) plans to save their own money for retirement, how well do the PEOs serve as fiduciaries? In at least one key respect, many PEO plans appear to put the employers first by advertising to employers that all asset and administration fees for their 401(k) plans are passed on to the employees. These employees are likely unaware that they may be paying hundreds of dollars in administrative fees, which more typically are paid for by the employer or shared.

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<sup>52</sup> Creative Staffing Systems ([www.ccs-peo.com](http://www.ccs-peo.com))

<sup>53</sup> [www.sunshine.com](http://www.sunshine.com)

<sup>54</sup> EBRI Databook on Employee Benefits, Employee Benefit Research Institute, 1997.



As with health benefits, federal tax laws require that benefit plans be ‘non-discriminatory’ to qualify for business tax deductions. The plans cannot be ‘top heavy’ with benefits for ‘highly compensated’ executives while excluding less-favored employees. Although the tax code requires employers to count “leased” employees in determining whether their retirement plans qualify, in reality large employers such as Microsoft disregarded this requirement, by simply considering these employees to be someone else’s employees when making this calculation.

Finally, numerous omissions on the IRS Form 5500s suggest that regulators are not paying much attention to the staffing industry’s filings. Given the financial history of this business, there appears to be a greater need for closer oversight by regulatory agencies.

## **PEOs and Workers’ Compensation Insurance**

The workers’ compensation insurance system is state-regulated and insures employers for health care and other costs incurred when workers are injured on the job. The PEO workers’ compensation practices have been just as fraudulent as their health insurance practices. According to the RAND report:

**Leasing firms...have been able to secure lower rates for workers’ compensation by: 1) claiming to be a new firm without any prior claims experience against which to rate, or 2) periodically changing the name of the leasing firm, leaving no claims trail for an insurer to check. By claiming to have “no prior experience,” a leasing firm’s premium will be set at the average for all such businesses. This (results in) substantially lower premiums to firms where the employees actually worked and accrued an unfavorable claims record.<sup>55</sup>**

Thus PEOs have been reselling workers’ compensation insurance to high-risk businesses and taking advantage of loose insurance underwriting practices to realize huge profits and growth from the mid-1990s until last year. New PEOs signed up employers with high workers’ comp insurance rates as PEO clients by offering them discounts of 20 percent or more on their insurance. PEOs sought out employers with workers’ compensation costs of \$3.00-15.00 per \$100 of wages—especially construction, trucking, cleaning

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<sup>55</sup> Leibowitz, *supra*, p. 27.

services, and nursing homes. After passing on discounts to employers, PEOs still had 30 percent or higher profit margins, creating millionaires just on discounting workers' comp insurance.

Eventually, these PEOs' workers' comp rates skyrocketed as all the worker injury claims from high-risk employers came in over a period of several years.<sup>56</sup> At this point, owners of many PEOs incorporated additional companies and "moved" the "employees" of the old PEO to the new PEO. Another tactic, "piggy-backing," is revealed in an PEO questionnaire used by American Safety Insurance Services:

**[Are there] any PEOs that piggyback on your program (piggybacking is an arrangement where another PEO signs up as a client company to access your workers' compensation program)?**

In addition to the fraudulent "new business" practices, PEOs engaged in employee misclassification to keep their rates down, according to business sources. For example, they might tell insurers that a machine shop client has "25 percent machinists, 25 percent sales, 25 percent clerical, and 25 percent supervisors, when a typical machine shop should have only about 10 percent of its payroll in clerical."<sup>57</sup> Insurers, for their part, were evidently not closely supervising how PEOs were "coding" employees. Insurers seem to ignore fraudulent underwriting by PEOs until most of the damage is done.

The rise of the PEO business mirrors discounted workers' compensation insurance rates in the 1990s and deregulation in some key markets, such as California, as insurers wrote cheap insurance to gain market share. As the workers' compensation market 'hardened' and rates increased last year, PEOs found themselves suddenly facing huge cost increases or no insurance at all, leaving their client employers without insurance. By the end of 2000, a number of PEOs were insolvent due to workers' compensation insurance problems, including **Employee Solutions, Inc**, a large Phoenix-based PEO. Insurers also became insolvent, including California-based **Superior National Insurance Group**.

**T.T.C., Illinois** has been penalized by the State of Florida and ordered to stop offering PEO services as of August 3, 2001. They were operating in various states, including Florida, without providing worker's compensation insurance for their employees — while

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<sup>56</sup> Some workers' comp claims are filed immediately. Other claims may not surface for years after the injuries or exposure took place. The "long claims tail" of workers' compensation is the period of years where claims continue to be filed at a slow rate.

<sup>57</sup> Barrow, Bob, "The Basics of Classification," *The ProEmp Journal*: April 2001.

telling employers they *had* insurance. The company has been unable to find another nationally-rated underwriter, a provision mandated by many states.

Finally, problems with workers' compensation are forcing some PEOs to abandon their traditional market in blue-collar industries and payroll more white-collar workers. **Staff Leasing Inc. (now Gevity HR)** opened its first office in New York City this year, and is planning to open similar offices in other major cities. *"With workers compensation costs soaring, Staff Leasing is seeking to move the bulk of its business out of the blue-collar marketplace to lower its liability."*<sup>58</sup>

To keep PEOs from causing more workers' compensation problems, **states should take action** to require PEOs and other staffing firms to accurately code workers and employers by sector and occupation.

### **Fraud, Bankruptcy and other Problems**

The nonpayment of state and federal payroll taxes by PEOs has been a significant problem recognized by the IRS in its *Tax Crimes* handbook and in surveys of state tax administrators. According to a Department of Labor study, 35 states have experienced problems with delinquent payroll taxes, 27 states had problems with firms declaring bankruptcy with unpaid unemployment insurance (UI) contributions, and 24 states said they identified firms that were manipulating payroll taxes.<sup>59</sup>

In recent well-publicized case, **Simplified Employment Services (SES)**, the nation's seventh largest PEO, filed for Chapter 11 in July 2001. SES was forced into bankruptcy after six banks suspended its accounts because of overdrafts of approximately \$32 million.<sup>60</sup> In April 2001, the IRS conducted what one agent called "possibly the largest raid in Michigan's history" at SES headquarters office. An estimated "1,700 boxes of records were seized...the most data we have ever taken at one location."<sup>61</sup> The raid comes after an investigation into mishandling of payroll taxes in the years 1996-2000. While the most PEOs have not been charged with illegal behavior, there are enough examples to warrant a closer look by regulators as the staffing industry seeks to expand.

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<sup>58</sup> Staffing Industry Analysts, Staffing Industry Report, July 13, 2001

<sup>59</sup> Department of Labor survey of states, 1997

<sup>60</sup> Staffing Industry Report, July 2001

<sup>61</sup> ProEmp Journal, May 14, 2001

## Public Policy: Can PEOs Legally sell Benefit Plans?

The term “leased employee” is a creation of the tax code.<sup>62</sup> Congress added it as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The tax law provision defines a leased employee as “any person who is not an employee [common law employee] of the recipient [employer] and who provides services to the recipient [employer].” In most cases, “leased employees” are a legal fiction.<sup>63</sup>

The PEOs are not in fact “*employers*” because the workers do *not* work for them and the PEOs do not supervise the workers. Since the PEOs are not the real employers of these workers, the IRS has questioned whether the 401(k) plans of PEOs meet federal tax laws (since all pension plans must be for the plan sponsor’s “employees” as defined in the tax law). The IRS has stalled on closing down PEO 401(k) plans to enforce the law because it could make employees eligible for the real employer’s own plans, which might create political problems for the IRS. However, the threat of IRS action still exists.

### PEOs Introduce Federal Legislation

The PEO business has moved to fix its tax code problem by introducing legislation that will codify PEOs as employers for the purposes of pension benefits under federal law. The Professional Employer Organization Workers Benefits Act of 2001 (H.R. 2807 and S. 1305), which is promoted by NAPEO, creates a “safe harbor” for “certified” PEOs who elect to be covered by the provisions of the law, including minimal bonding and auditing requirements. Reps. Rob Portman (R-Ohio) and Benjamin Cardin (D-Md.) introduced the legislation in August 2001, along with Senators Bob Graham (D-Fl.) and Chuck Grassley (R-Iowa).

This bill would permit employers to transform their employees into “leased employees” by using a PEO. Obviously, this weakens the link between the real employer and workers. It confuses employees on who the real employer is for enforcement of numerous federal laws designed to protect workers, including laws addressing discrimination, wage and hour, and workplace safety. The bill would require PEOs to offer a 401(k) plan to most worksite employees, but still doesn’t require any employer contribution.

Another PEO trade organization, the National Association for Alternative Staffing (NAAS), is planning to introduce different legislation in the near future, which will give

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<sup>62</sup> Internal Revenue Code §414(n)(2)

<sup>63</sup> An example of real leased employees would be the McDonnell Douglas employees who were temporarily loaned to Boeing several years ago when Boeing was behind in meeting airplane orders.

the PEOs the same “safe harbor” protection from the IRS, but without any bonding, audit or 401(k) requirements. The NAAS represents PEOs that believe in as little federal interference in the PEO business as possible.

## The Future of PEOs

PEOs currently face uncertainty as the economy slows, workers’ compensation and health care costs rise and new competition emerges offering employers similar competitive services. Despite this uncertainty, most experts are optimistic about prospects for the coming years. “*The future looks bright for PEOs*” agrees stock market analyst Judith Scott of Robert W. Baird & Co, and “*industry revenues could reach \$175 billion by the year 2006.*” The BLS estimates that the personnel supply service industry, which includes PEOs, has a projected growth rate of 3.7 percent over the period 1998-2008.<sup>64</sup> Currently, only 2 percent of employers with fewer than 500 employees use PEOs, leaving a lot of room for growth.<sup>65</sup> While the current slowdown in the economy has reduced the number of true temporary workers, the payrolling business may grow by offering employers a way to dramatically cut personnel costs and reduce the “headcount” of “regular” employees, always a “positive” sign to Wall Street analysts.

In order to exploit their potential growth, experts have identified some trends to watch for in the coming years. First, PEOs are prospering from the rush toward human resource “outsourcing,” which is focused on the shifting of employment management responsibilities from employer to outside agencies. PEOs already provide payroll processing for employers and the trend is for PEOs to take over the management of employee benefits, including offering many voluntary or optional services to employees, as well as selling extra health insurance and vacation packages. One model, the Administrative Service Organization (ASO), is Internet-focused. This allows client employers and worksite employees to access payroll, employee leave, and employee benefits information from a website database. The current trend toward financial services integration is also seen in the PEO world. Companies such as insurer CNA and Union Planters Bank promote their own PEO products. At the same time, PEOs are seeking insurance and banking networks to sell PEO services to their clients.

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<sup>64</sup> Thomson, Allison, “Industry Employment Projections to 2008,” Monthly Labor Rev., Nov. 1999, BLS, page 36

<sup>65</sup> Hirshman, Carolyn, HR Magazine, September 1997

The most likely trend in the near future is consolidation within the PEO business. It is widely expected that within the next few years, large PEOs will accelerate their acquisitions of smaller PEOs, leaving only a few major players. PEOs were hot properties in the second quarter of 2001. The popularity of the small PEOs is due in part to their low valuations, as a result of current troubles with workers compensation. “These companies are either going to get sold or go out of business,” said one analyst.<sup>66</sup> “It triggers a fire sale.” For example, **SES, Inc.** recently bought **United Staffing of America** and **Staff Leasing Corp.** After these acquisitions, SES filed for bankruptcy this summer in the aftermath of IRS payroll tax raids.

## Conclusions and Recommendations

PEOs and payrolling have grown faster than any other segment of the staffing business. There are at least as many people payrolled through PEOs and similar staffing firms as there are real temporary workers—nearly two million workers. This estimate does not count the large number of workers who are payrolled through other “non-staffing” companies (who will be the subject of future CFCW research). This growth raises several important questions about the role of PEOs and public policy. Do PEOs have any legitimate purpose that deserves special tax and legal treatment?

There is abundant evidence that PEOs are not upgrading most workers on their payrolls to “Fortune 500” benefits, as they claim. There is no evidence that “40 percent of companies using a PEO, upgrade their total employee benefits”<sup>67</sup> ... unless one counts benefits that employees must pay for, like expensive employee-paid optional health and disability plans, discounted amusement park tickets and cruise packages. The evidence suggests that even small employers generally provide better health and retirement security than PEOs. PEOs, along with other forms of nonstandard employment, have been a significant part of the problem by encouraging employers to move employees to PEO payrolls with inferior benefits. All the evidence leads to the conclusion that most PEOs are not improving employees’ benefits.

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<sup>66</sup> Staffing Industry Report, July 13, 2001

<sup>67</sup> NAEPO Statement to Dept. of Labor, 1999

If PEOs are not accomplishing their stated purposes, what are they doing? Staffing experts say that — now that the easy profits of skimming off workers' compensation insurance to employers are being questioned — PEOs are taking advantage of their 'employer' status to sell insurance products to captive employees of their clients.

Not only does selling insurance to captive employees raise troubling conflict of interest questions, it raises the question: how are PEOs regulated? As some PEO executives state, they need to “*convince regulators that PEOs are truly employers and not in the business of selling insurance.*” Since PEOs clearly are in the insurance business, regulators should be examining their business practices, just as preying on the elderly with deceptive Medicare supplemental plans has been exposed and reduced through regulatory efforts.

Now PEOs seek new federal and state legislation to allow expansion of the PEO business. It is time for state and federal policy makers to take a closer look at the business and determining how it should be regulated. This report makes the following recommendations:

- Congress should reject H.R. 2807/S. 1305, the legislation proposed by NAPEO and introduced by Reps. Rob Portman and Ben Cardin, and Senators Bob Graham and Chuck Grassley.
- Instead, Congress and the Department of Labor should investigate the performance of PEOs, and ask the following questions:
  - a) Are PEOs being used by employers to deny benefits to employees who would otherwise be in an employer's benefit plan?
  - b) Are PEOs in violation of HIPAA and state insurance laws by engaging in medical underwriting of individual workers in their group insurance plans?
  - c) Have PEOs breached their fiduciary duties as “co-employers” and plan administrators by selling expensive supplemental insurance to captive employees?
- The IRS should release the results of its confidential PEO *Market Segment Study Group* report determining whether PEOs are breaking federal pension laws that allow only legitimate employers to offer benefit plans.
- State insurance commissioners should investigate determine whether PEOs, as multiple employer health plans, have violated state insurance laws by discriminating against workers with pre-existing conditions, and through sales of ‘voluntary supplemental’ health and disability insurance policies to captive workers.

## Afterword

The publication of this report generated an immediate response from the PEO industry. NAPEO, the industry trade association, accused CFCW of “selectively-used facts,” “broad assertions of opinion,” and omissions of important details,” and NAPEO executive Milan Yager asserted that “if PEOs were breaking laws, authorities would be investigating and prosecuting them.” *ProEmp Journal* Editor Harry Feinberg accused the authors of quoting his statements out of context. None of these criticisms of the report have stated that CFCW got the facts wrong.

In fact, in a recent commentary in the *ProEmp Journal* on the report, insurance executive Bruce Leon concludes that there is a “real-life” basis for some of the report’s findings. Leon “agrees that this situation (the PEO practice of denying health benefits on the basis of an employee’s health conditions) is a violation of COBRA, ERISA and HIPAA.”<sup>1</sup>

Leon further notes that some PEOs have denied medical coverage to former employees of client employers who have a right to purchase insurance under COBRA. “This practice—known as ‘COBRA dumping’—violates many common insurance practices and is probably in violation of Dept. of Labor regulations.” Leon’s description confirms a complaint received CFCW received from a Chicago-area AIDS advocacy organization about a PEO refusing to provide COBRA coverage to former employees with pre-existing conditions.

Finally, a PEO account executive in a western state wrote CFCW to share his concerns with the PEO industry, especially in the area of supplemental insurance products as a profit center or offering inferior “self-insured” health plans. “I share your opinion that PEOs need to be highly regulated, especially in areas concerning the administration and offering of health benefits and qualified retirement plans,” said the executive, who wished to remain anonymous.

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<sup>1</sup> Leon, Bruce, “The Benefit Advantage,” *ProEmp Journal*, March 2002



### **Appendix I. Estimates of Size of PEO/Leasing Business**

Source	Number of PEO Firms	Number of Employees	Payroll (\$1,000s)
PEO Census <sup>i</sup>	917	-	-
ProEmp Journal <sup>ii</sup>	Approx. 1000	-	\$28 billion
NAPEO	Approx. 2,000	2-3 million	\$18 billion*
Staffing Industry Analysts - 1997	4766	895,411	19,223,761
Economic Census (1997) <sup>iii</sup>	3919	895,411	19,223,761**
HR Magazine <sup>iv</sup>	2500	> 2 million	-
BLS <sup>v</sup> (Estimate)	-	2.5 million	-

\* Includes benefits. \*\* Does not include employee benefits.

### **Appendix II. Industry Distribution of Leased Employees - 1997**

Industry where Leased Employees are Assigned	No. of Employees
Transportation	134,760
Manufacturing	104,415
Construction	102,123
Other Industries	92,716
Accommodations	77,311
Health and social services	58,363
Retail trade	57,236
Administrative and support services	48,304
Professional, scientific and technical services	47,987
Repair services	38,016
Wholesale trade	29,615
Real estate and rental/leasing	16,243
Finance and insurance	15,593
Personal care and laundry services	13,447
Arts, entertainment and recreational services	13,316
Information services	12,839
Agriculture, forestry, hunting and fishing	11,036
Educational services	7,565
Utilities (except waste management)	2,052
Mining	1,065
Total	884,002
1997 Economic Census - released March 2001	

### **Appendix III: Cost of Employee Benefits as Percentage of Payroll Cost - 2000**

	Legally-required Benefits*	Typical benefits: paid leave, insurance, retirement	Total benefits as percentage of payroll
White Collar	10.3%	21.3%	30.3%
Blue Collar	14.7%	23.3%	38%
Construction	16.4%	20%	36.4%
Small Business	12.3%	16.8%	29.1%
Average - all employers	11.9%	20.9%	32.8%

\*Social security, unemployment, workers' compensation.

Source: Costs for Employee Compensation, 1986-99, U.S. Dept of Labor, Bur. of Labor Statistics, 3/2000

**APPENDIX IV. State PEO Payrolling Activity**

<b>State</b>	<b>Receipts</b>	<b>Number of PEO Employees</b>	<b>Average Pay</b>
Alabama	363,952	14,780	\$ 20,709.27
Alaska	24,635	475	\$ 31,802.11
Arizona	1,056,329	55,618	\$ 16,586.59
Arkansas	250,388	11,894	\$ 18,274.51
California	1,991,195	68,456	\$ 24,118.43
Colorado	267,066	9,712	\$ 23,400.54
Connecticut	53,521	1,741	\$ 23,713.38
Delaware	4,320	294	\$ 8,914.97
District of Columbia	NA	NA	NA
Florida	4,497,512	199,646	\$ 18,165.45
Georgia	1,282,125	64,544	\$ 17,266.81
Hawaii	136,625	5,641	\$ 17,779.12
Idaho	25,376	890	\$ 24,038.20
Illinois	1,508,732	39,870	\$ 26,130.15
Indiana	539,308	15,767	\$ 25,778.14
Iowa	124,209	4,294	\$ 22,251.98
Kansas	NA	NA	NA
Kentucky	36,623	1,886	\$ 13,998.41
Louisiana	130,205	5,003	\$ 19,631.82
Maine	23,120	911	\$ 20,161.36
Maryland	244,530	7,689	\$ 25,785.02
Massachusetts	312,448	7,944	\$ 27,123.87
Michigan	1,396,966	40,063	\$ 29,286.70
Minnesota	308,950	11,106	\$ 21,097.15
Mississippi	151,176	6,157	\$ 20,640.57
Missouri	198,130	6,276	\$ 24,930.69
Montana	3,395	212	\$ 12,443.40
Nebraska	344,031	9,581	\$ 29,390.04
Nevada	134,063	3,479	\$ 25,005.46
New Hampshire	172,410	6,905	\$ 20,348.44
New Jersey	548,373	13,726	\$ 28,299.65
New Mexico	100,679	4,640	\$ 18,923.06
New York	640,796	25,436	\$ 20,210.49
North Carolina	337,306	13,270	\$ 18,282.97
North Dakota	987	110	\$ 6,481.82
Ohio	672,935	22,565	\$ 23,335.52
Oklahoma	179,820	6,017	\$ 25,016.95
Oregon	241,002	12,401	\$ 14,640.92
Pennsylvania	200,641	10,127	\$ 15,238.37
Rhode Island	NA	NA	NA
South Carolina	467,773	19,646	\$ 19,014.30
South Dakota	NA	NA	NA
Tennessee	481,435	15,444	\$ 23,986.66
Texas	3,398,424	106,126	\$ 25,686.09
Utah	554,682	19,438	\$ 20,361.30
Vermont	NA	NA	NA
Virginia	232,210	9,401	\$ 18,956.49
Washington	85,102	2,247	\$ 26,389.85
West Virginia	47,108	1,162	\$ 25,805.51
Wisconsin	100,880	4,326	\$ 19,403.84
Wyoming	NA	NA	NA
Total	23,871,493	886,916	21,307

## **APPENDIX V. – Estimates of Payrolled Workers**

According to the Economic Census, there were 2,612,719 employees of temp firms in the U.S. in 1997. Assuming that no more than 10 percent of the employees were the temp firms' own headquarters and branch office staff, there should have been approximately 2,351,447 workers assigned by temp firms. From the 1999 Contingent Work Survey (CWS), we know that 20 percent of so-called temp workers report their current employer assignment has lasted more than a year. A temp at the same assignment for at least a year is no longer a temp worker, but instead is a misclassified worker being payrolled through a staffing firm. This leads to the conclusion that approximately 470,000 so-called temp workers are actually permatemps, while 1,881,000 workers are real temporaries.

Using the same analysis, the CWS estimates that there were 769,000 "contract" workers. (The Economic Census does not identify contract workers separately from the industries where they work.) Contract workers can either be in temporary arrangement, or more frequently, in long-term permatemp assignments. The CWS estimates that 57 percent (438,000) of contract workers said that their current employer assignment had lasted a year or more. As with temps, if a contract worker is working at the same employer for a year or more the worker is likely misclassified. For example, a number of companies payroll contract workers for the oil industry—long-term workers that oil companies choose not have on their payrolls. This leads to an estimate of an additional 438,000 "permatemp" contract workers.

## **APPENDIX VI. - Classification of PEO Employees**

PEOs were part of SIC Code 7363 until 1997, when the North American Industry Classification System (NAICS) Code 561330 was developed for employee leasing/PEOs.

### **NAICS 56133: Employee Leasing Services**

This industry comprises establishments primarily engaged in providing human resources and human resource management services to staff client businesses. Establishments in this industry operate in a co-employment relationship with client businesses or organizations and are specialized in performing a wide range of human resource and personnel management duties, such as payroll accounting, payroll tax return preparation, benefits administration, recruiting, and managing labor relations. Employee leasing establishments typically acquire and lease back some or all of the employees of their clients and serve as the employer of the leased employees for payroll, benefits, and related purposes. Employee leasing establishments exercise varying degrees of decision making relating to their human resource or personnel management role, but do not have management accountability for the work of their clients' operations with regard to strategic planning, output, or profitability. Professional employer organizations (PEO) and establishments providing labor or staff leasing services are included in this industry. Source: <http://ftp.census.gov/epcd/ec97/def/56133.HTM>

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<sup>i</sup> PEO Census 2000 - op cit.

<sup>ii</sup> ProEmp Journal website, [www.peoinfo.com](http://www.peoinfo.com), PEO Questions and Answers

<sup>iii</sup> US Dept. of Commerce, 1997 Economic Census. No. of employees on payroll during week of March 12, 1997.

<sup>iv</sup> Hirshman, op cit.

<sup>v</sup> Estimate in material presented by Webster Graham, ES-202 Conference, Baltimore, MD, June 1996. The BLS does not formally estimate the number of workers payrolled by PEOs.



# POST-JOB OFFER MEDICAL HISTORY STATEMENT

NOTICE TO APPLICANTS: In compliance with the Americans with Disabilities Act of 1990, you have received a conditional offer of employment from this employer. The answers to this medical history statement and any medical examination will be kept confidential and in separate files by this employer. The job offer which you have received from this employer is "conditioned" upon the results of this medical history statement and any medical examination.

Full Name \_\_\_\_\_

Social Security Number \_\_\_\_\_ Drivers License Number \_\_\_\_\_

Home Address \_\_\_\_\_ Length of time at this address \_\_\_\_\_

Are you bothered with or have you ever had: (answer every item)

	Yes	No		Yes	No		Yes	No
1. Allergy			38. Pleurisy			60. Have you ever been treated for excessive use of alcohol or drugs?		
2. Anemic			39. Pneumococcus			61. Do you use drugs?		
3. Ankle pain			40. Pneumonia			62. Do you regularly take any medication?		
4. Asthma			41. Polio			63. Has your weight changed more than 15 pounds over the last 2 years?		
5. Blackout spells			42. Rheumatic Fever			64. Are you allergic to chemicals, dust, sunlight, or medications?		
6. Bladder trouble			43. Rheumatism			65. Have you had any serious illnesses?		
7. Chronic bowel trouble			44. High Blood Pressure, Stroke, or other disease(s) of the heart or Blood Vessels			66. Have you ever been refused employment because of your health?		
8. Brain tumors			45. Syphilis			67. In the past 10 years, have you been in a hospital, clinic or institution for examination, diagnosis, operation or treatment?		
9. Bronchitis			46. Thrombophlebitis			68. Do you contemplate surgery, or are you now receiving or do you contemplate receiving treatment or medication of any kind?		
10. Cancer or tumor of any kind			47. Tuberculosis			69. Have you ever requested or received a pension benefit or payment because of any injury, sickness or disability?		
11. Cerebral Palsy			48. Ulcer, disorder of the Stomach, Intestines, Liver or Gallbladder			70. In addition to any doctors or hospitals listed below, in the past 10 years have you: a) consulted any other doctor? b) been treated for any other cause(s) not named above?		
12. Chest Pains			49. Varicose Veins			71. If female, have you ever had any disorder of menstruation, female organs or breasts?		
13. Chronic bone infection			50. Wrist Pain					
14. Diabetes, thyroid or other endocrine disorder			51. Epilepsy, Seizures, Convulsions, Nervous Breakdown or any nervous or mental disease or disorder					
15. Disorder of eyes, ears, nose, throat or sinus			52. Arthritis, Gout or disorder of the muscles or bones, including the spine, back or joints, deformity, lameness or amputation					
16. Emphysema			53. Do you wear glasses or a hearing aid?					
17. Frequent Hoarseness			54. Do your feet give you trouble when you walk or stand for long periods of time?					
18. Fainting or dizziness			55. Have you ever had trouble with your back or neck?					
19. Frequent colds			56. Have you ever worn a back brace or support?					
20. Frostbite			57. Have you ever had any chronic back problems or back surgery?					
21. Goiter (thyroid)			58. Have you ever been advised to have or do you contemplate having surgery?					
22. Gonorrhea			59. Have you ever received treatment for emotional problems?					
23. Hay Fever								
24. Headaches (frequent or Migraine)								
25. Heat stroke								
26. Hemorrhoids								
27. Hemophilia								
28. Hernia or rupture								
29. Jaundice								
30. Kidney or urinary disorder								
31. Knee pain								
32. Lung or respiratory disorder								
33. Malaria								
34. Multiple Sclerosis								
35. Muscular Dystrophy								
36. Parkinson's Disease								
37. Persistent Cough								

Explain fully all "Yes" answers to questions 1 through 71 above. Include diagnosis, treatment, results, dates, durations and names and addresses of all **doctors and hospitals** (attach separate sheet[s] if necessary).