

Tax Memo

Our PEO Company (“BCC”) has developed a professional employer organization (“PEO”) program to provide lower cost health insurance, and other benefits, to small businesses and self-employed individuals.

You asked that we discuss the tax consequences of the PEO structure described below. For ease of understanding, we have broken the discussion into two parts, one part considering an employer which is an incorporated entity (either a C or S corporation), and the second considering self-employed individuals, partnerships, and limited liability companies. This distinction is necessary since a partner or member of a limited liability company cannot be an employee of the partnership or Limited Liability Company. Similarly, a self-employed individual operating as a sole proprietorship, in our view, cannot be an employee of his own proprietorship.

This memorandum addresses only the tax matters discussed herein. This memorandum does not discuss any insurance law, benefit law or employment law requirements or restrictions that may exist in any of the states in which BCC employs workers. It also does not discuss BCC’s PEO status, but assumes that status for purposes of this discussion. To comply with U.S. Treasury Department Circular 230, we hereby advise you that the tax discussions contained in this memorandum (i) are not intended or written to be used and cannot be used for the purpose of avoiding penalties imposed under the Internal Revenue Code of 1986, as amended (the “Code”), (ii) were written to support the promotion or marketing of the matters addressed in this memorandum, and (iii) you should seek tax advice based on your particular circumstances from an independent tax advisor.

Background

The PEO was developed by BCC to allow self-employed individuals, independent consultants, sole business owners, and others the ability to become part-time employees of BCC (“Worksite Employees”). BCC will then lease these individuals back to the self-employed individual, independent consultant or sole business owner (the “Worksite Employer”). The primary objective is to allow the Worksite Employer to provide health benefits to the Worksite Employee at a cost less than if the Worksite Employer were to contract for these benefits on its own. By creating a large group of covered individuals through the PEO structure, BCC is able to negotiate significant savings for the benefits provided to the Worksite Employees. BCC will also provide other benefits, as described below.

Should a Worksite Employer desire to take advantage of this program, its employees will become part-time employees of BCC. As such, they will qualify for various benefits provided by BCC, including medical insurance, life insurance, and disability insurance, and the opportunity to participate in a flexible spending account program (“FSA”) and BCC’s 401(k) plan.

Based on our review of the materials provided to us, it appears that the individuals employed by BCC will also remain employed by the Worksite Employer. The amount of compensation to be paid through BCC will be sufficient to qualify for the various insurance programs being provided; the remaining compensation will continue to be paid by the Worksite Employer. The Worksite Employee will be leased by BCC to the Worksite Employer, and the Worksite Employer will pay BCC a sufficient amount to cover all of the salary payments, taxes, unemployment compensation payments, and other amounts paid by BCC, reimbursement for all insurance premiums, and a fee to cover the services being provided by BCC.

Discussion

Incorporated Worksite Employer

If the Worksite Employer is incorporated, it is our view that the benefits set forth in the marketing materials we reviewed should be obtainable by the Worksite Employee and Worksite Employer. As a separate, incorporated entity, the Worksite Employer can employ not only the owners of the corporation, but also any other employees necessary to carry out the Worksite Employer's business. By having these employees, including the owners, become part-time employees of BCC, they would qualify to participate in the various benefit programs offered by BCC. We assume that the employment arrangement between BCC and each of the Worksite Employees will be such that the Worksite Employees will qualify for the various benefits being provided, including health insurance.

All of the fees paid by the Worksite Employer to BCC should be deductible by the Worksite Employer. From the Worksite Employee's standpoint, his or her compensation will be the same as if he or she were employed solely by the Worksite Employer, the only difference being that he or she will receive two W-2 forms, one from BCC for the wages paid by BCC, and one from the Worksite Employer.

Note, however, that this arrangement may result in additional Social Security taxes being paid by the Worksite Employer. Because the Worksite Employee is employed by two separate employers, each employer is required to both withhold Social Security and Medicare taxes and pay its share of those taxes. Since the Worksite Employer is reimbursing BCC for any of the taxes BCC has paid on the salaries it pays to the Worksite Employee, the Worksite Employer is paying all of these taxes. The social security tax is 6.2% of wages, up to wages of \$97,500 for 2007. Therefore, if the total compensation being paid to a Worksite Employee by both BCC and the Worksite Employer exceeds this amount, the Employer will be paying more social security taxes than if the Worksite Employee had been employed solely by the Worksite Employer. From the Worksite Employee's standpoint, any social security taxes withheld in excess of the maximum would be creditable against his or her income tax liability for the year. Since there is no cap on Medicare taxes (1.45% of wages), no additional Medicare taxes will be paid under the PEO structure.

The Worksite Employee may be able to reduce his or her taxable income by participating in the various programs offered by BCC. For example, to the extent that any portion of the premiums for the health insurance is to be paid by the Worksite Employee, the Worksite Employee can agree to have those premiums paid through BCC's FSA on a pre-tax basis. Similarly, the Worksite Employee can elect to have a certain amount of his or her compensation withheld and deposited into the FSA on a pre-tax basis to be used to pay for medical expenses not otherwise covered under the medical insurance policy, deductibles, and co-payments. Further, the Worksite Employee can, through the FSA, pay for dependent care expenses on a pre-tax basis.

The Worksite Employee can also elect to participate in the BCC 401(k) plan by agreeing to have a portion of his or her pay contributed, on a pre-tax basis, to the plan, up to the stated allowable annual limit. As discussed in the last section of this memorandum, this will require that the plan structure be adjusted from that described in the marketing materials.

Self-Employed Individuals

The results are less clear with respect to a self-employed individual. For this purpose, we consider self-employed individuals to include not only a sole proprietor, but also a partner in a partnership or a member of a limited liability company taxed as a partnership. Under the Code, each of these individuals is considered to be self-employed, and not an employee. For the sole proprietor, all of the income and expenses related to his or her business are reported on Schedule C on his or her tax federal return, and to the extent that there are net earnings from self-employment, the individual is subject to the self-employment tax

(“SECA”), and not the Social Security and Medicare taxes (“FICA”). A partner’s or member’s share of the income of the partnership or Limited Liability Company is reported on a Schedule E, and that amount is also treated as self-employment income subject to the SECA tax.

The Internal Revenue Service’s (“Service”) position that a partner cannot be an employee of a partnership has been upheld by the courts. See, Estate of Tilton, 8 BTA 914 (1927); Commissioner v. Moran, 236 F.2d 595 (8th Cir. 1956); Commissioner v. Robinson, 273 F.2d 503 (3d Cir., 1959); Commissioner v. Doak, 234 F.2d 704 (4th Cir. 1956). In light of this position, it is not clear whether a partnership or limited liability company would be considered to be an entity separate and apart from its partners or members so that it could lease the services of a partner or member from BCC. The Service could contend that since a partner or member cannot be an employee of a partnership, the partnership or Limited Liability Company cannot obtain these services indirectly through a PEO. We have found no authority specifically addressing this issue. However, if the Service were to successfully so contend, only certain of the PEO benefits would be available to the self-employed individual, assuming for this purpose that the contractual arrangements between the partner or member and BCC are enforceable. Further, the self-employed individual’s SECA taxes would be more than the FICA taxes payable under the corporate alternative since medical insurance premiums paid by an employer are deductible for FICA purposes but not SECA purposes. Nevertheless, due to the lack of any direct authority on this issue, we do not believe it would be unreasonable for a partner or member employed by BCC to prepare his or her personal tax returns on the basis that the employment relationship with BCC will be recognized for Federal income tax purposes.

This uncertainty also exists for the sole proprietor. The issue is whether an individual, as a sole proprietor, can contract with a third party (BCC) for his own services. Since a sole proprietor does not exist as an entity separate and apart from the individual himself or herself, there is a significant risk that the Service would take the position that a sole proprietor cannot contract with the PEO for his or her own services. Although we have found no specific cases addressing this issue, the cases cited above strongly indicate that this would be the case. For example, in Estate of Tilton, *supra*, the Board of Tax Appeals specifically stated, in concluding that a partner cannot be an employee of a partnership that “no man can be his own employer or employee.” Similarly, in Commissioner v. Doak, *supra*, the Court stated that “a partnership has no legal existence independent from the individual partners.” If the Service were to successfully contend that the sole proprietor cannot contract for his or her own services through BCC, then we believe, again assuming the contractual arrangements between BCC, the individual and the Worksite Employer are enforceable, BCC would be deemed a purveyor of services and benefits to the sole proprietor, and that the compensation paid by BCC would be deemed paid as an agent on behalf of the Worksite Employer. Nevertheless, due to the lack of any direct authority on this issue, we do not believe it would be unreasonable for a self-employed individual employed by BCC to prepare his or her personal tax returns on the basis that the employment relationship with BCC will be recognized for Federal income tax purposes.

Notwithstanding how the relationship between the parties may be treated for tax purposes, the intention of the parties is to enter into contractual arrangements binding each of them. Thus, the Worksite Employee enters a contract with BCC to become its employee and to provide various services for BCC. In return, BCC agrees to pay compensation to the Worksite Employee, and to provide the employee with certain benefits and the opportunity to participate in certain BCC benefit programs. We assume, notwithstanding how this arrangement may be viewed from a tax standpoint, that this is an enforceable contract under state law. Similarly, we assume that the contract between BCC and the Worksite Employer is enforceable under state law. Thus, the ultimate question is what are the tax consequences under these binding contractual arrangements if they are not treated for tax purposes as creating an employment arrangement between BCC and the self-employed individual.

If the employment relationship between BCC and the self-employed individual is accepted by the Service, then the results would be the same as those described above for the incorporated Worksite Employer. However, should the IRS view the structure as not creating an employment relationship, the tax

consequences would be different than those described above for a corporate employer. Note that if a sole proprietor is interested in obtaining all of the benefits available to a corporate employer, he or she should consider incorporating his or her business. This alternative approach is also available for partnerships and limited liability companies, although it may be more difficult to implement as there may be other factors weighing against having the partnership or limited liability company convert to a corporation.

BCC Fees

BCC's invoices to the Worksite Employers will set forth in detail the various services provided and the fees for those services, including the net salary paid, reimbursement for Social Security and Medicare taxes, workers compensation and unemployment insurance, and medical insurance premiums paid. Even if the Service were not to recognize the employment relationship between BCC and the self-employed individual, the fees for the specific services provided by BCC (i.e., BCC's service fee and fee for insurance and retirement planning and other business advice) would be deductible by the Worksite Employer.

Health Insurance Benefits

Except as to SECA taxes described below, it is our view that the tax consequences with respect to health insurance are the same as in the case of the incorporated Worksite Employer. Should the IRS not accept the employment arrangement between BCC and the partner, member or sole proprietor, it is our view that the partnership, limited liability company or sole proprietorship would be deemed to have made a payment of the medical insurance premiums through BCC on behalf of the partner, member or sole proprietor. Under current tax law, medical insurance premiums paid by a self-employed individual (whether partner, member or sole proprietor) are fully deductible as a deduction to arrive at adjusted gross income. Therefore, they are not subject to any reduction applicable to itemized deductions.

Life Insurance Premiums

The tax results with respect to life insurance premiums are different if the employment relationship between BCC and the self-employed individual is not recognized. Unlike employees, self-employed individuals are not entitled to exclude from gross income the cost of the first \$50,000 of group term life insurance provided by their employer. Thus, if life insurance is provided through the PEO arrangement with BCC, the premiums paid for the life insurance on the self-employed individual (which are reimbursed to BCC by the Worksite Employer) would not be deductible by the partnership, limited liability company or sole proprietorship, nor would the partner, member or sole proprietor be entitled to deduct those costs on his or her own individual tax return.

Disability Insurance

Similarly, disability insurance premiums cannot be deducted by a self-employed individual. However, if no tax deduction has been taken for the payment of disability insurance premiums, any amounts received in the event of disability are excluded from gross income. If the premiums were deducted, any benefits would be subject to tax. Although there may be some loss of deduction currently, the self-employed individual may be better off if a claim is made.

Flexible Spending Account

A self-employed individual is not entitled to participate in an FSA. This applies both to the sole proprietor as well as partners of partnerships and members of limited liability companies. Thus, if the employment relationship between BCC and the self-employed individual is not recognized by the Service, the self-employed individual cannot elect to have any portion of the compensation paid by BCC paid into BCC's FSA.

401(k) Plan

A partnership, limited liability company or sole proprietor can adopt a 401(k) plan. Therefore, subject to the following discussion, this benefit is fully available to self-employed individuals.

SECA Taxes

If the employment arrangement between BCC and the self-employed individual is not accepted by the Service, the SECA taxes payable by the self-employed individual would be greater than the FICA and SECA taxes payable if the employment relationship were recognized. To understand this, assume for a given year that BCC will pay wages to a Worksite Employee of \$20,000, and \$6,000 in health insurance premiums and the Worksite Employer will reimburse BCC for these payments and pay \$4,000 in fees to BCC. Assume, finally, that the net income of the self-employed individual before any payments to BCC for the wages, insurance premiums or BCC fees is \$50,000.

If the employment relationship is accepted by the Service, the self-employed individual will have \$20,000 of self-employment income (\$50,000 minus \$20,000 salary minus \$6,000 medical insurance premiums minus \$4,000 BCC fees), and \$20,000 of wages on which FICA taxes will be withheld, for a total of \$40,000.

If, however, the employment arrangement is not accepted by the Service, then the self-employed individual will have self-employment income of \$46,000: the \$50,000 earned by the proprietorship minus the BCC fees of \$4,000. An additional \$6,000 is subject to the SECA tax. The reason for this increase is that medical insurance premiums paid by an employer on behalf of an employee are not included in income for FICA tax purposes, but medical insurance premiums paid on behalf of a self-employed individual do not reduce self-employment income.

Credit for FICA Taxes

Regardless of how the employment arrangement between BCC and the self-employed individual is ultimately treated for tax purposes, we assume BCC will be withholding income and FICA taxes, and remitting these taxes on the wages that it pays to the self-employed Worksite Employee. If this arrangement is not accepted as an employment arrangement by the Service, will the self-employed individual be properly credited with the taxes that BCC actually withholds and pays?

We believe that the self-employed Worksite Employee should get credit against his or her SECA tax liability for the FICA taxes that were paid on his or her behalf. This may have to be negotiated with the Service at the time that an examination occurs questioning how the arrangements with BCC were reported on the return as originally filed. Assuming a self-employed individual is willing to take a chance that the employment relationship between it and BCC is valid for tax purposes, the self-employed reports on his or her tax return the wages paid by BCC, and the net income from the proprietorship or partnership. In calculating his or her self-employment tax on Schedule SE, credit would be taken for the taxes paid on the wages paid by BCC.

If the IRS examines the return and successfully contends that there was no employment relationship between BCC and the self-employed individual, all of the various payments made to BCC will be recharacterized as set forth above, and the amount of self-employment income will be increased, and the wages will be eliminated. At this point, the amount of self-employment tax will be calculated and will obviously exceed the amount of self-employment tax paid with the original return. In negotiating with the IRS with respect to this matter, the self-employed individual can contend that he or she should get credit for the FICA taxes withheld by BCC. These amounts were paid by the self-employed individual, as they were deducted from his or her gross salary. To deny this credit would unjustly enrich the Service for amounts the self-employed individual actually paid to the Service (by way of withholding).

The more interesting question is how the employer's share of FICA taxes on these wages should be handled. Since these were also paid by the self-employed individual, indirectly by his or her payments to BCC, should they also be credited against the self-employed individual's SECA liability? Although we know of no authority with respect to this, it seems to us that the most equitable way to properly account for the fact that taxes were remitted on behalf of the individual would be to provide him or her with a full credit for the all FICA taxes that were paid and withheld by BCC on his or her behalf. Nevertheless, it must be recognized that we could find no authority that would specifically require the Service to provide such a credit, and this is a risk which the self-employed individual needs to consider, and whether to seek a better alternative, such as incorporating his or her business.

BCC 401(k) Plan

The Service issued a Revenue Procedure in 2002 which addressed the handling of defined contribution plans, such as a 401(k) plan, sponsored by a PEO. The Revenue Procedure noted that the qualification of a defined contribution plan depends, in part, on the benefits of the plan being limited to the employers of the sponsor. Where an individual is employed both by the PEO and the Worksite Employer, the Revenue Procedure determined that such an arrangement would violate the rule, and provided alternatives for solving the problem. The first alternative was for the PEO to terminate its plan, which is obviously not acceptable to BCC. The second alternative was for the PEO's defined contribution plan to be converted to a "multiple employer" plan. This alternative is the only methodology which can be used for BCC to provide 401(k) benefits to the Worksite Employees.

A multiple employer plan is a plan which covers a group of unrelated non-union employees. In essence, each unrelated employer becomes a co-sponsor of the plan to provide benefits to its employees. For tax purposes, any employee of any sponsor is treated as an employee of all of the sponsors for qualified plan purposes. Thus, for example, services performed for two or more of the co-sponsors in a given year would be combined for purposes of determining an employee's vested benefit in the plan. This is of little significance to BCC since it is our understanding that the 401(k) plan will provide only for benefits deferred by the participants and that no matching or employer contributions will be made. Since all employee contributions have to be fully-vested when made, this does not become an issue.

If the Worksite Employer maintains its own separate 401(k) plan, it is possible that a Worksite Employee participating in both the Worksite Employer's plan and BCC's plan could contribute more than this allowable maximum. For 2007, the maximum amount that an employee can contribute to a 401(k) plan is \$15,500 (plus an additional \$5,000 if the employee is age 50 or older). This limit applies per individual, regardless of how many employers he or she may have. Thus, if more than \$15,500 is contributed in combination by BCC and the Worksite Employer, a refund of the excess contribution will be required, and some coordination between the two plans will be necessary.

There also may be some reporting issues with respect to the plan. If further information is necessary with respect to this aspect of the program, we would be happy to provide it to you in a separate memorandum.