

Client Alert

A report
for clients
and friends
of the firm February 2003

Important Information Affecting Employers That Use Staffing and Payroll Organizations

Businesses that utilize an employee leasing organization or other staffing firm to supply workers on a contractual basis may be faced with some important decisions in 2003, if the staffing firm also provides a single employer retirement plan for worksite employees. Pursuant to Internal Revenue Service ("IRS") Revenue Procedure 2002-21, there is a one-time window this year to either convert such a plan to a multiple employer plan or to terminate it. As a result, many of these staffing firms will be presenting their client businesses with choices to be made under the Procedure, which should be carefully evaluated.

In a typical employee staffing arrangement, a staffing firm, commonly referred to as a professional employer organization or "PEO," enters into a service agreement with an employer, or "Client Organization," to provide personnel who will work on-site at the Client Organization, or to provide payroll and/or other services to the Client Organization. The IRS refers to employees who receive compensation from a PEO pursuant to a service agreement with the Client Organization as "worksite employees."

These worksite employees are normally compensated directly by the PEO and, in some cases, also participate in a defined contribution retirement plan sponsored by the PEO (e.g., a 401(k) plan). PEOs generally have considered themselves to be either the common law employer of the worksite employees, or a co-employer or "joint" employer of the worksite employees along with the Client Organization. However, the IRS has noted that there are situations, based on all of the relevant facts and circumstances, where it may not be entirely apparent which entity is actually the employer of worksite employees. Thus, it was frequently unclear under the tax law whether a PEO should use a single employer plan for all worksite employees or a multiple

employer plan, under which each Client Organization adopts the plan for its particular worksite employees.

In recognition of the complexities involved in determining which entity is the "employer" and the need for all parties to have some degree of certainty as to the status of retirement plans for worksite employees, the IRS has established in Revenue Procedure 2002-21 a safe-harbor procedure for PEOs which, if followed, will permit PEOs that currently sponsor single employer plans for worksite employees to have some assurance that their defined contribution retirement plans will continue to be in compliance with the tax law. As will be discussed in greater detail below, one of the options provided to those PEOs under Revenue Procedure 2002-21, and the option that most PEOs likely will select, is to convert the single employer plan to a multiple employer plan, and permit each Client Organization whose worksite employees participate in the plan to join the multiple employer plan as a sponsoring employer.

The following generally describes the IRS safe harbor offered under Revenue Procedure 2002-21 and the decisions that must be made by organizations using PEOs that provide defined contribution retirement plans.

Choices Available to a PEO Under Revenue Procedure 2002-21

To obtain relief under Revenue Procedure 2002-21, a PEO sponsoring a single employer plan for worksite employees must make a decision (and take certain specified actions affirming its decision) by the date that is 120 days after the first day of the plan year beginning after January 1, 2003 (the "PEO Decision Date") to either terminate the plan or convert the plan to a multiple employer plan in accordance with the procedures set forth by the IRS. The PEO Decision Date for a calendar year PEO plan is May 2, 2003.

Once the PEO makes its decision to terminate the plan or convert it into a multiple employer plan, it must take all remedial actions required by the last day of the plan year beginning after January 1, 2003 (the "PEO Compliance Date"). The PEO Compliance Date for a calendar year PEO plan is December 31, 2003.

Since the ability to provide retirement benefits to worksite employees typically is an important component of a PEO's business, it is likely that most PEO's will choose the conversion option rather than the termination option. Regardless of which course of action is selected by the PEO, the PEO must provide certain notifications to its Client Organizations with worksite employees who are participants in a PEO retirement plan, and ask the Client Organizations to make certain elections with respect to the treatment of its worksite employees. These Client Organization notifications and elections must be accomplished between the PEO Decision Date (generally May 2, 2003) and the PEO Compliance Date (generally December 31, 2003).

Thus, companies utilizing the services of a PEO that provides a single employer defined contribution plan to worksite employees should soon be contacted by the PEO, if that has not already occurred, regarding the decisions that have to be made for the future of the retirement plan. Companies in this position should carefully consider these decisions and consult with legal counsel before taking any action, since there may be important consequences depending on which option is chosen, e.g., the possible impact on other tax-qualified plans that an organization may sponsor for its regular employees.

Plan Conversion Option

If the PEO chooses to convert its single employer plan to a multiple employer plan, the PEO must provide by the PEO Decision Date (May 2, 2003 for calendar year plans) a notice to each Client Organization that has worksite employees participating in the plan setting forth the options available to the Client Organization. The notice must specify a date by which each Client Organization must notify the PEO of the option it selects.

The options available to Client Organizations if the PEO selects the Plan Conversion option are as follows:

Option 1 – Adoption of the Multiple Employer Retirement Plan

The Client Organization may elect to adopt the PEO multiple employer plan for its worksite employees. The Client Organization must then take action to adopt the multiple employer plan by the first day of the plan year following the PEO Compliance Date (or any earlier date specified by the PEO). If the Client Organization elects this option, the multiple employer plan will be deemed to comply with relevant tax rules regardless of whether the worksite employees are common law employees of the PEO or the Client Organization.

The day-to-day operation of the multiple employer plan by the PEO should not be much different than its current operation of the single employer plan as far as the Client Organization is concerned. However, a multiple employer plan differs from a single employer plan primarily in that top heavy, minimum coverage and nondiscrimination testing must be performed separately for each adopting Client

Organization, taking into account that Client Organization's (and its affiliates') employees. Thus, a Client Organization will need to provide the PEO (or its third-party administrator for the multiple employer plan) with demographic and other information necessary to perform these tests. A failure of one Client Organization to properly perform or satisfy these tests could adversely affect the tax-qualification of the entire plan.

Option 2 – Transfer Assets and Liabilities to the Client Organization Plan

A Client Organization may elect to have the assets and liabilities attributable to its worksite employees (and former worksite employees) in the PEO plan transferred to another defined contribution retirement plan that the Client Organization sponsors, or a new plan that is established to receive these transferred assets. In order to elect this option, the Client Organization is required to provide the PEO plan with copies of the receiving plan's most recent IRS determination letter and the receiving plan must preserve all "protected benefits" with respect to the transferred assets. For example, any optional forms of payment that were available to employees under the PEO plan must be made available under the Client Organization's plan.

Option 3 – Spinoff Assets and Liabilities to a Separate Plan and Termination of that Plan.

A Client Organization may elect to have the assets and liabilities attributable to its worksite employees (and former worksite employees) in the PEO plan transferred to a separate temporary retirement plan that will be terminated on or before December 31, 2003 (or the last day of the 2003 plan year for non-calendar year plans). Once the plan is terminated, participants will receive distributions from the plan that may be rolled over into another eligible retirement plan or IRA. However, if a Client Organization elects this option, its ability to maintain a 401(k) plan for its employees may be limited under the Internal Revenue Code for 12 months. This option is the default option if a Client Organization does not timely specify another option to the PEO.

Plan Termination Option

As described above, a PEO may choose to terminate the plan, effective as of the first day of the plan year following the PEO Compliance Date (January 1, 2004 for calendar year plans). As with the Plan Conversion option, if the PEO chooses this option, the PEO must provide by the PEO Decision Date a notice to each Client Organization that has worksite employees participating in the plan setting forth the options available to the Client Organization and the date by which each Client Organization must notify the PEO of the option it selects. Under the Plan Termination option, a Client Organization has available Options 2 and 3 specified above for a Plan Conversion.

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EDITOR'S COMMENT: If your organization uses a PEO, has not been contacted about this issue, and is uncertain as to whether Revenue Procedure 2002-21 applies, you should promptly contact your PEO for information. As noted above, most PEOs probably will be converting their plans into multiple employer plans (rather than terminating their plans), in which case affected organizations must decide whether to become participating employers in the PEO plan. Since there may be many factors to consider when making any of the elections described above, it is advisable to consult with legal counsel before finalizing a decision.

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Client Alert

Proskauer Rose LLP's nationally recognized Employee Benefits and Executive Compensation Law Group includes over three dozen attorneys and other professionals whose range of skills covers the entire spectrum of employee benefits and executive compensation law. The following individual serves as a contact person and would welcome any questions you might have.

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