

Certified Professional Employer Organization or Professional Employer Organization and the R&D Tax Credit: Why should you care?

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Background

A Certified Professional Employer Organization (“CPEO”) is an entity that enters into an agreement with a customer to perform some or all of the federal employment tax withholding, reporting, and payment functions related to workers performing services for the customer. For purposes of federal employment taxes and other obligations under the federal employment tax rules, the CPEO is generally treated as the sole employer of any individual performing services for a customer of the CPEO that is covered by a contract between the CPEO and the customer. However, special rules apply to the eligibility to claim certain tax credits under a CPEO contract.

Rules

Internal Revenue Code (“IRC”) §3511, rules governing CPEOs was introduced in

mid-2016; however, it has a significant impact on the ability of an employer to claim the R&D tax credit. As more and more companies are relying on CPEOs to manage their payroll responsibilities, this has become an important issue to address.

IRC § 3511(d) provides that for purposes of claiming certain tax credits, including the R&D tax credit, the customer and not the CPEO shall be treated as the employer of work site employees. Therefore, wages paid to a work site employee can be claimed as qualified wage expenses by the customer.

A *work site* means a physical location where an individual regularly performs services for a customer of a CPEO. If there is no such physical location, the location would be the location from which the customer assigns work to the individual. A work site cannot be the individual's residence or a telework site unless the customer requires the individual to work at that site. Contiguous locations are treated as a single physical location.

A *work site employee* is defined as a covered employee who performs services for such customer at a work site where at least 85 percent of the individuals performing services for the customer are covered employees of the customer. The determination of whether an employee is a work site employee is made on a calendar quarter basis. Therefore, a covered employee will be considered a work site employee for the entire calendar quarter. An employee can be a work site employee during one calendar quarter and a non-work site employee during a different calendar quarter in the same tax year.

Summary

As we evaluate eligibility for the R&D tax credit, it is important to understand whether the business is handling payroll in-house, using a CPEO or using a non-certified PEO. To date, there has been no specific guidance issued regarding the ability for an employer contracting with non-certified PEOs to claim the R&D tax credit.

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