

Interim Guidance Under Section 7705 for Certified Professional Employer Organizations

Notice 2016-49

I. PURPOSE AND OVERVIEW

This notice provides interim guidance on certain requirements for persons seeking certification as Certified Professional Employer Organizations (CPEOs), as defined in §301.7705-1T(b)(1). The Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) recently issued temporary and proposed regulations under section 7705 of the Internal Revenue Code (Code) addressing the requirements relating to applications for and maintenance of certification as a CPEO, as well as a revenue procedure setting forth detailed procedures for applying for certification as a CPEO. Treasury and IRS have received comments that certain provisions of the regulations and revenue procedure may unnecessarily limit the ability of persons to apply for and maintain certification as a CPEO, including: (1) the requirement that a CPEO applicant, as defined in §301.7705-1T(b)(2), or CPEO provide a certified public accountant (CPA) opinion that its annual audited financial statements reflect positive working capital (or meet certain rules that permit negative working capital in limited circumstances) and that it computes its taxable income using an accrual method of accounting; (2) the requirement that a CPEO applicant or CPEO submit a written

declaration of an independent CPA, who submits opinions and attestations regarding the CPEO applicant's or CPEO's annual audited financial statements and ongoing federal employment tax compliance, declaring that the CPA is authorized to represent the CPEO applicant or CPEO before the IRS; and (3) the requirement that a CPEO be a business entity that is not a disregarded entity. This notice describes modifications to these requirements that Treasury and IRS intend to make when publishing final regulations and updating the revenue procedure. Taxpayers may rely on the guidance provided in this notice until the final regulations and updated revenue procedure are published.

In addition, Treasury and IRS are aware that, for persons submitting applications during the first year of the program, the audited financial statements that must be included as part of the application for certification might not include some of the elements required by the regulations because the statements relate to fiscal years that end before or shortly after the regulations were issued. To address this issue, this notice provides transition relief for meeting the audited financial statement requirements in the regulations and revenue procedure.

Finally, in recognition that this notice provides interim guidance on requirements applicable to persons who may already be engaged in the process of applying for certification as a CPEO, this notice extends to September 30, 2016, the deadline by which a complete and accurate application for certification must be submitted in order to be eligible for an effective date of certification of January 1, 2017.

II. BACKGROUND

The Stephen Beck, Jr., Achieving a Better Life Experience (ABLE) Act of 2014, enacted on December 19, 2014, as part of The Tax Increase Prevention Act of 2014 (Pub. L. No. 113-295), added new sections 3511 and 7705 to the Code relating to the federal employment tax consequences and certification requirements, respectively, of a CPEO. The ABLE Act requires the establishment of a voluntary program for persons to apply to become certified as a CPEO. Temporary and final regulations (TD 9768) describing the requirements relating to applications for and maintenance of certification were published in the Federal Register on May 6, 2016 (81 Fed. Reg. 27315). Proposed regulations (REG-127561-15), also published in the Federal Register on May 6, 2016 (81 Fed. Reg. 27360), provide guidance on the federal employment tax liabilities and other obligations of persons certified by the IRS as CPEOs, propose to adopt the text of the temporary regulations by cross-reference, and solicit public comments on the provisions contained in both the proposed and temporary regulations. Rev. Proc. 2016-33, 2016-25 I.R.B. 1034 (released June 4, 2016), sets forth detailed procedures for applying for certification as a CPEO. A future revenue procedure will address requirements for a CPEO to remain certified and the procedures relating to suspension and revocation of CPEO certification.

III. REQUIREMENT FOR A CPA OPINION REGARDING THE CPEO APPLICANT'S OR CPEO'S WORKING CAPITAL AND METHOD OF ACCOUNTING

The temporary regulations and Rev. Proc. 2016-33 provide guidance on the statutory requirements for certification as a CPEO, pursuant to section 7705. Specifically, section 7705(b) sets forth the certification requirements that a person must satisfy in order to become a CPEO. Among other requirements, a person must

demonstrate that it meets such requirements as the Secretary shall establish, including requirements relating to tax status, background, experience, business location, and annual financial audits; agree to satisfy (on an ongoing basis) certain bond and independent financial review requirements; and compute its taxable income using an accrual method of accounting unless the Secretary approves another method. Section 7705(c) prescribes the bond and independent financial review requirements that a person must satisfy to become and remain a CPEO. Under section 7705(c)(3)(A), a CPEO must, as of the most recent audit date, cause to be prepared and provided to the Secretary (in such manner as the Secretary may prescribe) an opinion of an independent CPA as to whether the CPEO's financial statements are presented fairly in accordance with generally accepted accounting principles (GAAP). Section 301.7705-2T(e)(1)(i) reiterates this statutory requirement, while §301.7705-2T(e)(2) describes how this requirement applies to CPEO applicants.

As explained in the preamble to the temporary regulations, Treasury and IRS consider a CPEO with annual audited financial statements that reflect positive working capital (as determined in accordance with GAAP) to present a materially lower risk to the IRS's collection of federal employment taxes than a CPEO without such financial statements. Accordingly, pursuant to section 7705(b)(1) and consistent with several state certification and registration laws governing professional employer organizations, §301.7705-2T(e)(1) requires a CPEO applicant or CPEO to cause to be prepared and provided to the IRS, by the same date by which it must provide its annual financial statements to the IRS, an opinion of an independent CPA that the financial statements reflect positive working capital for the fiscal year or that the CPEO applicant or CPEO

satisfies the requirements of §301.7705-2T(e)(3) (the exception to the positive working capital requirement). In addition, the temporary regulations require this opinion to set forth in detail a calculation of the CPEO applicant's or CPEO's working capital. In the case of a CPEO applicant that is a member of a controlled group of which other members are CPEO applicants or CPEOs, section 2.05(6) of Rev. Proc. 2016-33 clarifies that the CPEO applicant must submit copies of combined or consolidated annual audited financial statements for all CPEO applicants and CPEOs in the controlled group and an accompanying unmodified opinion of a CPA that such financial statements are presented fairly and in accordance with GAAP. The statements and opinion must contain the name and employer identification number (EIN) of each CPEO applicant and CPEO in the controlled group, as well as the name and EIN of controlled group members that are not CPEO applicants or CPEOs, if the statements and opinion include such members. A CPEO applicant that is a member of a controlled group of which other members are CPEO applicants or CPEOs must also submit an opinion of a CPA that the individual CPEO applicant's financial statements reflect positive working capital (as defined by GAAP) or that the requirements of §301.7705-2T(e)(3) are satisfied, with the opinion in either case setting forth a calculation of the individual CPEO applicant's working capital.

Consistent with section 7705(b)(4), §301.7705-2T(l) requires a CPEO to compute its taxable income using an accrual method of accounting or, if applicable, another method that the Commissioner provides for in further guidance. Further, section 2.05(2)(c) of Rev. Proc. 2016-33 requires the CPA opinion accompanying submission of

the annual audited financial statements to reflect that the CPEO applicant computes its taxable income using an accrual method of accounting.

Treasury and IRS have received comments suggesting that CPAs may be prevented from including statements on working capital and the accrual method in their opinions due to certain American Institute of Certified Public Accountants (AICPA) limitations on what can be included in a CPA opinion. These commenters have requested clarification that the inclusion of these items in the financial statements, which are covered by the CPA opinion, rather than in the CPA opinion itself, would satisfy the regulatory requirements.

To ensure consistency with the AICPA guidelines applicable to CPA opinion letters, Treasury and IRS anticipate revising the requirements of §301.7705-2T(e)(1) and section 2.05(2) of Rev. Proc. 2016-33 to require a CPEO applicant or CPEO to submit a copy of its annual audited financial statements and an unmodified opinion of a CPA that the annual audited financial statements are presented fairly in accordance with GAAP, provided that the audited financial statements covered by the opinion include a Note to the Financial Statements that states that the financial statements reflect positive working capital or that the CPEO applicant or CPEO satisfies the requirements of §301.7705-2T(e)(3). The Note described in the previous sentence must also provide in detail a calculation of the working capital. In the case of a CPEO applicant that is a member of a controlled group of which other members are CPEO applicants or CPEOs, the Note to the Financial Statements of the combined or consolidated annual audited financial statements for the controlled group must state that the individual financial statements of each CPEO applicant or CPEO that is a member

of the controlled group reflect positive working capital (as defined by GAAP) or that the individual CPEO applicant or CPEO satisfies the requirements of §301.7705-2T(e)(3), in either case setting forth in detail a calculation of each individual CPEO applicant's or CPEO's working capital. Similarly, Treasury and IRS anticipate revising the requirements of section 2.05(6) of Rev. Proc. 2016-33 to allow the name and EIN of each member of the controlled group that is included within the consolidated audited financial statements of the controlled group to be listed in either the Note to the Financial Statements or in a separate attachment signed by a responsible individual of the CPEO applicant or CPEO under penalties of perjury, rather than in the CPA opinion.

Because GAAP requires the use of an accrual method of accounting and the required CPA opinion must state that a CPEO applicant's or CPEO's audited annual financial statements are presented fairly in accordance with GAAP, the separate requirement in paragraph (c) of section 2.05(2) of Rev. Proc. 2016-33 for a CPA opinion stating that such financial statements "reflect that the CPEO . . . computes its taxable income using an accrual method of accounting" is unnecessary. Treasury and IRS anticipate revising Rev. Proc. 2016-33 to eliminate paragraph (c) of section 2.05(2).

IV. TRANSITION RELIEF FOR CPEO APPLICANTS SUBMITTING ANNUAL AUDITED FINANCIAL STATEMENTS FOR FISCAL YEARS ENDING BEFORE SEPTEMBER 30, 2016

Section 301.7705-2T(e)(2) and section 2.05(1) of Rev. Proc. 2016-33 require a CPEO applicant to provide to the IRS, with its application, a copy of its annual audited financial statements for the most recently completed fiscal year as of the date it applies for certification, as well as a CPA opinion with respect to those statements (as described in §301.7705-2T(e)(1) and section 2.05(2) of Rev. Proc. 2016-33, and further

addressed in section III of this notice). If a CPEO applicant applies for certification before the last day of the sixth month following its most recently completed fiscal year, and the audit of the financial statements for that fiscal year has not been completed at the time of application, a CPEO applicant must provide with its application the annual audited financial statements and opinion for the immediately preceding fiscal year, if any, and must subsequently provide to the IRS by the last day of the sixth month after that fiscal year ends the annual audited financial statements and opinion for the most recently completed fiscal year. In addition, for any fiscal year that ends after the CPEO applicant submits its application for certification and on or before the effective date of certification, if applicable, the CPEO applicant must provide the annual audited financial statements by the last day of the sixth month after such fiscal year ends. The obligation of a CPEO applicant to provide a copy of its annual audited financial statements and an opinion for the most recently completed fiscal year as of the date it applies for certification continues even if the CPEO applicant is certified as a CPEO before the IRS has received the annual audited financial statements.

Treasury and IRS have received comments expressing the concern that, for persons applying for certification in the first year of the program, the regulatory requirements regarding submission of annual audited financial statements and CPA opinions with respect to those statements apply to fiscal years predating promulgation of the temporary regulations for which the audit is already closed and could require a CPEO applicant to undertake the costly process of amending prior financial statements or conducting financial audits of those years anew. In response to this concern, this notice provides transition relief for any CPEO applicant required to submit a copy of its

annual audited financial statements and CPA opinion with respect to a fiscal year ending before September 30, 2016, as a part of its application for certification. Specifically, a CPEO applicant will not fail to meet the requirements of §301.7705-2T(e)(2) or section 2.05(1) and (2) of Rev. Proc. 2016-33 if the CPEO applicant submits, together with annual audited financial statements for a fiscal year ending before September 30, 2016: (1) an unmodified opinion of a CPA that the annual audited financial statements are presented fairly in accordance with GAAP; and (2) a separate statement, signed under penalties of perjury by a responsible individual of the CPEO applicant, that the financial statements reflect positive working capital for the fiscal year or that the CPEO applicant satisfies the requirements of §301.7705-2T(e)(3), in lieu of such information being provided in the CPA opinion or in a Note to the Financial Statement, as described in section III of this notice. The statement by the responsible individual must also provide in detail a calculation of the CPEO applicant's working capital. In the case of a CPEO applicant that is a member of a controlled group of which other members are also CPEO applicants or CPEOs, the CPEO applicant must submit its own separate statement by a responsible individual that the individual financial statements of that CPEO applicant reflect positive working capital (as defined by GAAP) or that the requirements of §301.7705-2T(e)(3) are satisfied, in either case setting forth in detail a calculation of the individual CPEO applicant's working capital.

Regardless of its fiscal year end date, a CPEO applicant has until the last day of the sixth month after the end of its fiscal year to submit the annual audited financial statements, accompanying CPA opinion, and, if applicable, separate statement of positive working capital, signed by a responsible individual, for that year. For example,

if a CPEO applicant with a fiscal year ending September 30, 2016, submits an application for certification on September 14, 2016, the CPEO applicant must provide with its application the annual audited financial statements and CPA opinion for its most recently completed fiscal year (the year ending September 30, 2015), which qualify for the transition relief described in the preceding paragraph. In addition, the CPEO applicant will have until March 31, 2017 (the last day of the sixth month after that fiscal year ends), to subsequently provide to the IRS annual audited financial statements (as well as the accompanying CPA opinion) for the year ending September 30, 2016, that comply with the requirements described in §301.7705-2T(e) and section 2.05 of Rev. Proc. 2016-33 (and with the anticipated revisions to these requirements that Treasury and IRS intend to make when publishing final regulations and updating the revenue procedure, as described in section III of this notice).

V. DEFINITION OF CERTIFIED PUBLIC ACCOUNTANT

In accordance with section 7705(c)(3)(A), the temporary regulations require the opinion regarding a CPEO's financial statements to be provided by a CPA who is independent of the CPEO. For this purpose, §301.7705-1T(b)(4) and section 1.01 of Rev. Proc. 2016-33 require a CPA to be independent as prescribed by the AICPA's Professional Standards, Code of Professional Conduct, and its interpretations and rulings. Additionally, §301.7705-1T(b)(4) and section 1.01 of Rev. Proc. 2016-33 provide that, among other requirements, the CPA must file with the IRS a written declaration that he or she is currently qualified as a CPA and authorized to represent the CPEO applicant or CPEO before the IRS. A similar written declaration must accompany the quarterly submission of the examination level attestation of a CPA that

the CPEO applicant's or CPEO's assertion that it has withheld and made deposits of all federal employment taxes for which the CPEO applicant or CPEO is liable for the quarter, as required by §301.7705-2T(f), is fairly stated in all material respects. See Rev. Proc. 2016-33, §2.06(2).

Treasury and IRS have received comments raising a concern that the requirement that a CPA be authorized to represent the CPEO or CPEO applicant before the IRS could conflict with CPA independence requirements of the AICPA. To ensure that the CPA may be "independent" within the meaning of the AICPA guidelines, Treasury and IRS anticipate revising the definition of "certified public accountant," as set forth in §301.7705-1T(b)(4) and section 1.01(3) of Rev. Proc. 2016-33, to omit the requirement that the CPA file with the IRS a written authorization to represent the CPEO applicant or CPEO before the IRS. Accordingly, the revised definition of "certified public accountant," to be provided in the final regulations, will refer to a CPA who—

- (i) With respect to a CPEO applicant or CPEO, is independent of the CPEO applicant or CPEO (as prescribed by the American Institute of Certified Public Accountants' Professional Standards, Code of Professional Conduct, and its interpretations and rulings);
- (ii) Is not currently under suspension or disbarment from practice before the IRS;
- (iii) Is duly qualified to practice as a CPA in any state;
- (iv) Files with the IRS a written declaration that he or she is currently qualified as a CPA; and
- (v) Meets such other requirements as the Commissioner may prescribe in further guidance.

Furthermore, section 2.06(2) of Rev. Proc. 2016-33 will be revised to require that the written declaration accompanying the quarterly examination level attestation state only that the CPA is currently qualified as a CPA.

VI. REQUIREMENT THAT A CPEO BE A BUSINESS ENTITY THAT IS NOT A DISREGARDED ENTITY

The temporary regulations provide in §301.7705-2T(c)(2) that a CPEO may not be a business entity that is disregarded as an entity separate from its owner for federal tax purposes under §§301.7701-2 and 301.7701-3 (without regard to the special rule in § 301.7701-2(c)(2)(iv) that provides that such entities are corporations for federal employment tax purposes¹). Commenters have explained that professional employer organizations are structured in varied ways, and that it is not uncommon for professional employer organizations to be entities disregarded as separate from their corporate, partnership, or individual owner. Commenters emphasized that professional employer organizations may choose such a structure for legitimate business reasons, such as to reduce the overall compliance burden with respect to filing of state income tax returns. Commenters expressed concern that precluding disregarded entities from being certified as CPEOs would unfairly prevent a number of existing professional employer organizations from applying to the CPEO program without undergoing restructuring.

To address this concern, and in recognition that disregarded entities are generally treated as corporations for federal employment tax purposes, Treasury and IRS anticipate that the final regulations under section 7705 will not prohibit a business

¹ Section 301.7701-2(c)(2)(iv)(B) provides that, with certain exceptions, an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2 is treated as a corporation with respect to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).

entity that is disregarded as separate from its owner under §§301.7701-2 and 301.7701-3 from becoming a CPEO. Instead, it is anticipated that the final regulations will provide that a business entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2 and that is wholly owned directly (including through one or more disregarded entities organized in the United States) by a United States person (as defined in section 7701(a)(30)) may apply for certification as a CPEO. Treasury and IRS anticipate that, consistent with §301.7705-2T(d)(1), the final regulations will continue to require that a CPEO applicant or CPEO must be created or organized in the United States or under the law of the United States or of any state. Therefore, only domestic disregarded entities would be eligible to apply for certification. Treasury and IRS request comments on the appropriateness of allowing a disregarded entity that is domestically organized but not wholly owned directly by a United States person to apply for certification as a CPEO.

In addition, Treasury and IRS anticipate revising the definition of “responsible individual,” as provided in §301.7705-1T(b)(13) and section 1.01(11) of Rev. Proc. 2016-33, to also include: (1) in the case of a disregarded entity owned by a corporation or partnership, the responsible individuals of that corporation or partnership (as defined by the regulations); and (2) in the case of a disregarded entity owned by an individual, the individual owner. Finally, Treasury and IRS anticipate providing in the final regulations that CPEO applicants and CPEOs that, but for their status as disregarded entities would separately be members of a controlled group, are treated as members of a controlled group for purposes of section 7705 and related regulations.

The temporary regulations also provide in §301.7705-2T(c)(2) that a CPEO must be a business entity described in §301.7701-2(a). Because an individual conducting business through a sole proprietorship is not a business entity described in §301.7701-2(a), an individual may not be a CPEO under the temporary regulations. One commenter expressed concern that this rule precludes certification of smaller professional employer organizations that are operated by individuals through their sole proprietorships. In response to this comment and to ensure parity between sole proprietorships and disregarded entities that are wholly owned by individuals, Treasury and IRS anticipate that the final regulations will expressly allow sole proprietorships to apply for certification as a CPEO.

VII. EXTENSION OF APPLICATION SUBMISSION DEADLINE FOR JANUARY 1, 2017, EFFECTIVE DATE

A person seeking certification as a CPEO must submit a properly completed and executed application for certification as a CPEO in the time and manner prescribed by, and providing such information required by, §301.7705-2T, Rev. Proc. 2016-33, and instructions accompanying the application. The IRS will issue a notice of certification to a CPEO applicant that has been approved for certification specifying the effective date of certification. The first sentence of section 6.03 of Rev. Proc. 2016-33 provides the general rule that the effective date of certification will typically be the first day of the first calendar quarter following the date of the notice of certification. However, the second sentence of section 6.03 of Rev. Proc. 2016-33 provides the special rule that a CPEO applicant that submits a complete and accurate application before September 1, 2016, and is certified will have an effective date of certification of January 1, 2017, even if the date of the CPEO's notice of certification is after January 1, 2017.

In recognition that this notice provides interim guidance regarding documents that must be submitted as a part of an initial application for CPEO certification and will directly affect applications by persons interested in seeking CPEO certification that are already in progress, Treasury and IRS are extending the period in which a person must apply in order to be eligible for an effective date of January 1, 2017, under the second sentence of section 6.03 of Revenue Procedure 2016-33. CPEO applicants now have until before October 1, 2016, to submit an application for certification in order to be eligible for a January 1, 2017, effective date. That is, the effective date of certification for a CPEO applicant that submits a complete and accurate application for certification on or before September 30, 2016, and is certified will be January 1, 2017, even if the date of its notice of certification is after January 1, 2017.

VIII. RELIANCE

Treasury and IRS intend that the final regulations under section 7705 and the updated revenue procedure, when issued, will address the issues identified in this notice in the manner indicated in this notice. Pending the issuance of final regulations and the updated revenue procedure, taxpayers may rely on the guidance contained in this notice.

IX. DRAFTING INFORMATION

The principal authors of this notice are Melissa L. Duce and Andrew K. Holubeck, Office of Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Duce at (202) 317-6798 or Mr. Holubeck at (202) 317-4774 (not toll-free numbers).