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Tax Factors and Planning Strategies Involving Domestic and Cross-Border Employee Leasing

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1. Introduction

On April 4, 2003, the Internal Revenue Service (IRS) and Treasury Department announced that they intend to put an end to a cross-border employee-leasing tax-avoidance ploy used by many doctors, dentists and other professionals.¹ The IRS encouraged participating professionals to come clean through a voluntary compliance program, while undertaking a significant number of audits to clamp down on the practice. In fall 2003, the probe grew to include two-dozen companies with \$10 million or more in assets whose deferred-compensation plans using employee-leasing programs are under intense IRS scrutiny.²

This paper gives an overview of the fast-growing employee-leasing sector and examines the tax factors and tax-planning strategies involving the increasingly popular practice. The paper then describes the mechanics of the employee-leasing offshore deferred-compensation shelter known as the Irish leasing scheme,³ which the IRS designated as a *listed transaction* on April 4, 2003.⁴ Finally, the paper examines the principles and reasoning employed by the IRS to challenge employee-leasing arrangements in recent rulings and notices.

2. Overview of Employee Leasing

An employee-leasing company, also referred to as a professional employer organization (PEO), leases employees or their services to *recipient companies*, usually small businesses, private practices and individual proprietorships. Smaller companies stand to save most by using a PEO, since they have higher per-worker employment costs. According to the Small Business Administration, companies with fewer than 500 employees spend about \$5,000 annually per employee on regulation, paperwork and tax compliance, while those with more than 500 employees average about \$3,500 per year per employee (*CMU* 2001). PEOs create economies of scale that lower employment costs to small businesses and offer their employees otherwise unaffordable services and benefits.

In a typical PEO arrangement, the small-business recipient company pays a standard contract price (the gross payroll plus a service fee) to the PEO, which in turn assumes responsibility for obligations related to human resources, workers' compensation, payroll,

¹ John D. McKinnon, IRS, "Treasury aim to eliminate employee-leasing tax dodge," *Wall Street Journal*, April 7, 2003, A4.

² Mary Dalrymple, "IRS looking into compensation packages for chief executives," *Associated Press Newswires*, December 5, 2003.

³ When this tax shelter was first introduced, it was often constructed with Ireland (a low-tax country) as the foreign country involved; hence its name. The Irish leasing scheme subsequently came to be constructed involving a number of different foreign countries, so at present its relation to Ireland is purely nominal.

⁴ Regulation §1.6011-4T(b)(2) defines *listed transactions* as those transactions that are the "same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction." The range of listed transactions covers a broad spectrum of tax issues. A cumulative list of transactions the IRS considers to be tax-avoidance transactions is published periodically (see Notice 2000-15, 2000-12 I.R.B. 826, supplemented and superseded by Notice 2001-51, 2001-34 I.R.B. 190).

labor-law compliance and employment taxes. In addition, through the services of a PEO, small businesses are able to offer their workers competitive health insurance, disability insurance and other expanded benefits under the PEO's overall corporate plan. Many PEOs offer additional value-added services, such as employee background checks, applicant drug tests, supplemental employee benefits, employee outplacement assistance, etc. The recipient company retains responsibility for day-to-day management of the employees, maintains hire-and-fire authority, handles promotions and provides workplace supervision.

The PEO is responsible for maintaining compliance with all regulations regarding the reporting and payment of federal, state and local taxes on wages paid to the workers. The PEO is recognized by the IRS as the *employer of record* for liability for federal income and unemployment taxes. As such, the PEO is required by law to withhold and remit federal employment taxes on a quarterly basis. These taxes include federal income tax, Social Security and Medicare taxes and unemployment tax. Most states impose similar withholding, depositing and reporting requirements for state (and local) employment taxes.

Employee leasing has been around since the 1970s, when physicians who wanted to set up lucrative retirement plans for themselves but not for their employees shifted their staff to the payroll of leasing firms and leased them back, technically turning their practices into one-person businesses. This discriminating practice was struck down because retirement tax law sets standards for determining who an employer is and generally requires that companies offer the same retirement programs to all employees. Today, employee leasing is widespread and fast growing, and industry experts estimate that two to three million Americans are currently co-employed in a PEO arrangement. PEOs are operating in every state, and the industry continues to grow at an average of 20 percent each year. Today, records suggest that there are around 800 PEOs—down from more than 3,000 three years ago—that are responsible for generating more than \$43 billion in gross revenues (NAPEO).

3. Tax Factors in Employee Leasing

Leasing in general has numerous tax implications and, by decoupling the ownership and the use of an asset, gives rise to a number of tax-planning strategies. For example, leasing allows a shift of asset ownership—and thus the benefits of depreciation expense—to the tax clientele that can best utilize these deductions. Furthermore, lease payments are generally recognized as deductible business expenses and can create additional tax savings for lessees. In addition to these *pocket-shifting* possibilities, leasing creates the potential for expense *type-shifting* by substituting, for example, depreciation for lease expense, which in different circumstances and jurisdictions may trigger considerably different treatment for

tax purposes.⁵ Finally, leasing transactions often illustrate the link between taxes and asset prices, as, for example, lessors can pass on the tax savings they realize from the transaction to lessees by quoting a lower lease payment.

Employee leasing exhibits all the tax characteristics of general leasing transactions and has additional, even more exotic tax implications. Businesses use employee leasing most widely as a pocket-shifting tax strategy. Often, the small-business recipient companies that enter into PEO arrangements are either in a low tax bracket or are loss-making entities. By transferring its payroll burden to a higher-tax-bracket PEO that can utilize the deductions, a small business can receive some of the benefit back in the form of a lower lease payment for the leased employees. Many states offer tax credits for job creation, which a low-tax-bracket or loss-making small business may not be able to utilize fully. If instead a high-tax-bracket PEO creates the jobs and leases the employees to the small business, the profitable PEO can utilize the credits and pass on a portion of the benefit to the recipient company (Skowronski 2003).

Similarly, employee leasing is sometimes utilized in joint ventures between tax-exempt nonprofit organizations and for-profit companies—employees of the tax-exempt organization are leased to the joint venture or the for-profit counterpart, generating lease-payment deductions for the tax-paying party while triggering no tax for the leasing income realized by the nonprofit (Friz 1998). In offshore employee-leasing deals, such as the Irish leasing scheme (see section 4), high-income professionals shift part of their income to an entity in a tax haven or tax-treaty jurisdiction, shielding the offshore amount from U.S. federal taxes.

Businesses also can sometimes use employee-leasing transactions as a type-shifting strategy applied to expenses rather than to income. For example, some states that levy business taxes do not allow companies to deduct compensation expenses over a certain limit, in essence levying a value-added tax on service organizations, such as banks and law firms, with greater concentrations of highly paid staff. To avoid this, such firms can lease their employees from a PEO that has a lower concentration of high-income employees and is thus able to utilize more compensation deductions. Meanwhile, the service firm can deduct the entire lease expense. Industry research shows that such firms can realize savings of 16 to 45 percent of their business tax bill (Grajewski 2000).

⁵ *Pocket-shifting* refers to a tax planning strategy that involves transferring taxable income from one tax-paying entity (usually in a high marginal tax-rate bracket) to another entity (usually in a low marginal tax-rate bracket or with a tax-free status). *Type-shifting* refers to a tax planning strategy that involves transforming taxable income from one type (usually taxed at a high rate—e.g., regular income) to another (usually taxed at a lower rate—e.g., capital gain).

In relatively less common and more complex shelter vehicles, employee leasing can also be used to implement *time-shifting* strategies.⁶ As the Irish leasing scheme (see section 4) illustrates, employee leasing can be applied to engineer offshore deferred-compensation arrangements for key employees. These schemes have the usual benefit of delaying taxes on contributions, but unlike regular deferred compensation plans, they allow the U.S. employer to claim a deduction immediately in the form of a lease expense, while also often giving the employee tax-free access to the offshore funds through foreign credit cards and loans.

When analyzing the tax factors of employee leasing, one must understand which types of taxes the practice most commonly affects. Employee leasing has an impact on three types of taxes on both the federal and the state level: employment taxes, corporate income taxes and individual income taxes.

Employment taxes include federal income tax, Social Security and Medicare taxes and unemployment tax that the employer is required by law to withhold on a quarterly basis. Businesses must deposit withheld amounts in an authorized bank or financial institution pursuant to federal tax deposit requirements, and failure to do so results in either civil penalties when unintentional or criminal charges when deliberate. Most states impose similar withholding, depositing and reporting requirements for state (and local) employment taxes.

When a recipient company enters into a PEO arrangement and leases its employees, the responsibility for withholding and paying employment taxes shifts to the PEO. This usually affects the timing and amount of tax withholding and remittance. This is an area that has seen considerable abuse and has attracted increased IRS scrutiny of employee-leasing organizations. According to the IRS, from 1998 through July 2001 it initiated 168 employment-tax evasion investigations. These resulted in 154 criminal convictions, with an average prison term of 17 months for the violators, in addition to civil penalties (Leeds 2001).

Very often, employee leasing is structured to have a direct impact on the corporate income taxes of the recipient company (lessee), the PEO (lessor) or both. By applying the type-shifting and pocket-shifting strategies described earlier, companies can reduce their income-tax liabilities and the amount of tax paid. Employee leasing can also affect individual income taxes, either by manipulating the amounts withheld by the PEO or by devising innovative tax vehicles, such as the Irish leasing scheme (see section 4), which

⁶ *Time-shifting* refers to a tax-planning strategy that involves delaying the payment of taxes by shifting reported taxable income to a later time period, thus benefiting from the time value of money and potentially from a reduced future tax rate.

shelters a large proportion of an employee's income through an offshore deferred-compensation plan.

An important element that often shapes the tax consequences of employee leasing is the current legal definition of the terms *employee* and *employer*. Despite the decades-long existence of the practice of employee leasing, the legal status of PEOs as employers and of leased staff as employees is not explicitly established by and protected under U.S. law. The rights and responsibilities that would normally ensue from such legal status have usually been defined in and enforced through the contractual arrangements made between the PEO, the recipient company and the leased employees.

But these contracts are generally governed by a patchwork of state and federal rules and regulations that, in the absence of standardization, have often caused confusion. The failure to explicitly define PEOs as the legal employers has left unresolved numerous areas of accountability and potential liability while jeopardizing the tax-favored status of benefits for leased employees and deductibility of some employee-leasing expenditures (Moline 1999).

The IRS has its own guidelines for testing employer status by examining three general categories of evidence: behavioral control, financial control and relationship of the parties (Hutzelman 2001). Behavioral control examines whether there is a right to direct or control how the employee performs the specific task for which he or she is engaged; financial control bears on the right to direct or control how the employee's activities with a direct business impact are conducted; and relationship of the parties pertains to how the parties perceive their relationship. Recently, lawmakers in the House of Representatives introduced two separate bills that seek to amend the Internal Revenue Code to clarify the legal status of PEOs as employers and allow them to sponsor welfare and benefit plans.⁷

4. Employee-Leasing Tax Shelter: The Irish Leasing Scheme

The offshore deferred-compensation shelter also known as the Irish leasing scheme, which the IRS designated as a listed transaction on April 4, 2003, embodies most of the tax factors and strategies described in the previous section. In this scheme, an individual resigns from his or her employment with a U.S. corporation and becomes an employee of a foreign leasing corporation, which then indirectly leases the individual's services to the original U.S. employer. Different schemes show some variation in structure, but this shelter generally works as follows (IRS 2003):

First, an individual terminates his or her official existing employment relationship with a U.S. corporation (*U.S. recipient corporation*) of which he or she may be direct or indirect and partial or sole owner. The individual then enters into an employment relationship with

⁷ U.S. Congress, House, H.R. 1270, March 13, 2003, H1900; U.S. Congress, House, H.R. 2178, May 21, 2003, H4527.

a foreign leasing corporation incorporated and managed in a country with which the United States has an income-tax convention. The foreign leasing corporation leases the right to the individual's services in the United States to a U.S. leasing corporation. The U.S. leasing corporation, in turn, leases the individual's services back to the U.S. recipient corporation.

Before entering into the arrangement, the individual has little or no business relationship with either the foreign leasing corporation or the U.S. leasing corporation. After entering into the arrangement, the individual continues to provide "substantially the same services" for the U.S. recipient corporation that he or she provided before entering into the arrangement, and the involvement of the foreign and U.S. leasing corporations has no significant effect on the individual's performance of services for the U.S. recipient corporation.

The U.S. recipient corporation makes payments to the U.S. leasing corporation for the individual's services. The U.S. leasing corporation pays only a small portion of these amounts to the individual for his or her services. After deducting a fee for its participation in the arrangement, the U.S. leasing corporation remits to the foreign leasing corporation the remainder of the amount it received from the U.S. recipient corporation in return for the individual's services.

The foreign leasing corporation deducts a fee from the amount paid by the U.S. leasing corporation and typically credits the remainder to an account maintained on behalf of the individual. In certain cases, the foreign leasing corporation transfers the remainder to a trust for the benefit of the individual. Although the assets of the trust may be nominally subject to the claims of the foreign leasing corporation's creditors, it is typically difficult or impossible for creditors of any of the three corporations involved to reach the assets of the trust in the event of insolvency or bankruptcy of any of these entities.

Often, the arrangement is designed to provide the individual, either directly or indirectly, with explicit or implicit control over the amounts held on his or her behalf by the foreign leasing corporation or the trust. For example, the arrangement may permit or require the foreign leasing corporation to provide the individual with a device, such as a credit or debit card, for paying personal, business or professional expenses out of such amounts. Alternatively, the scheme may permit the individual to submit bills and receipts for payment or reimbursement from such amounts or to borrow against such amounts.

For tax purposes, the individual claims that only the compensation actually paid to him/her by the U.S. leasing corporation should be included in current gross personal income and that amounts held by the foreign leasing corporation or the trust on his or her behalf are deferred compensation.

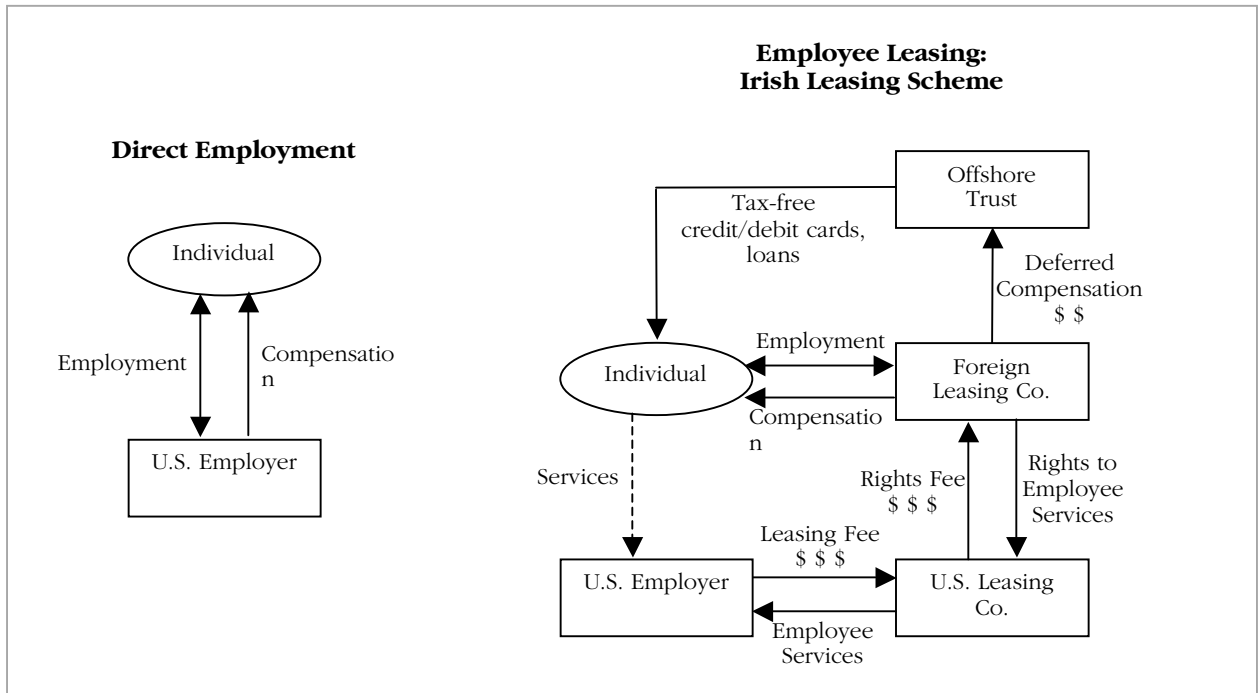
The U.S. recipient corporation claims the entire amount paid to the U.S. leasing corporation in return for the individual's services as a deductible trade or business expense under section 162 of the Internal Revenue Code and thus does not report, withhold or pay any portion of this amount for federal tax purposes.

The U.S. leasing corporation claims both the compensation paid to the individual and the amount paid to the foreign leasing corporation as a deductible trade or business expense. The U.S. leasing corporation does not treat the amount paid to the foreign leasing corporation as compensation to the individual and thus does not report, withhold or pay any portion of this amount for federal tax purposes.

The foreign leasing corporation claims that it is a resident of a country with which the United States has an income tax convention and therefore entitled to all of the benefits afforded under that convention. It also takes the position that, pursuant to the convention, no portion of the amount paid to it by the U.S. leasing corporation is subject to U.S. income tax, because such amount is business profits that are not attributable to a permanent establishment in the United States.

Figure 1 compares the exchange of services and funds in a simple direct employment with an employee-leasing arrangement using the Irish leasing scheme.

Figure 1. Flow of Services and Moneys



This scheme results in multiple tax benefits: First, the original U.S. employer deducts the payment to the U.S. leasing corporation as a business expense that is not reported on Form 1099 or subject to income-tax withholding or payroll taxes. This is an example of a type-shifting strategy, whereby payroll expense is transformed into leasing expense.

Second, the U.S. leasing corporation deducts the payments to the employee and to the foreign leasing corporation and the reporting and withholding tax on the wages it pays to the individual, but not on the payments to the foreign leasing corporation. This is an example of a pocket-shifting strategy, whereby the individual's income is split between two accounts, one taxable and the other not.

Third, the foreign leasing corporation claims that the amount it receives from the domestic U.S. leasing company is not subject to U.S. tax under the treaty between its country and the United States. This is another example of a pocket-shifting strategy, whereby a portion of the taxable income is transferred to a tax-treaty foreign entity.

Fourth, the individual pays tax only on the amount he or she receives from the U.S. leasing company. This is an example of a time-shifting strategy, whereby a portion of the personal income is treated as deferred compensation, which in many cases is never taxed. In effect, the scheme produces a deferred compensation plan that also allows the employer (the U.S. recipient corporation) to take an immediate full deduction for the entire amount of the deferred pay (unlike regular deferred compensation plans).

5. IRS Ruling and Reasoning

The IRS has outlawed the Irish leasing scheme and has made it clear it will challenge similar transactions and pursue offenders to the full extent of the law. Its goal is either to ensure that deferred pay is included in an individual's current gross income or to disallow the deduction of the individual's deferred income by the original U.S. employer.

The shelter can be attacked on the basis of several doctrines and principles. The fundamental doctrine underlying the IRS's position is *substance over form*—the form of the transaction has changed, but the substance has not; therefore taxes payable should be the same (IRS 2003). The IRS is also challenging the scheme under the *economic benefit* doctrine, which postulates that a taxpayer using the cash receipts and disbursements method of accounting must include in current gross income any financial or economic benefit derived from the absolute right to receive property in the future that has been set aside for the taxpayer in a trust or fund. In addition, the IRS is invoking the *assignment of income* doctrine, whereby the party that earns the income is taxed on that income, regardless of whether earnings occurred through the direct efforts of the party or through the party's ownership of an asset that generates income. Finally, the IRS is challenging the

arrangement using the *cash equivalency* doctrine, which maintains that a taxpayer is treated as having income when he or she receives property that is the equivalent of cash.

Of these four doctrines, substance over form builds the most compelling case against the Irish leasing scheme, as the others carry additional burdens of proof to establish economic benefit, earning of income or cash equivalency.

6. Conclusion

Employee leasing creates opportunities for all three basic kinds of tax planning: pocket-shifting, type-shifting and time-shifting. The tax implications of employee leasing also have a direct impact on the pricing of professional and employee services. Tax shelters based on employee-leasing arrangements have been widespread among high-income professionals, and the practice has become increasingly commonplace among corporations.

However, the IRS has strongly challenged the legitimacy of employee-leasing tax schemes on the basis of several fundamental doctrines, including substance over form and economic benefit. In addition to providing a valuable benefit to small businesses, employee leasing has frequently been abused in fraudulent and constructive tax-avoidance schemes, of which the recently uncovered Irish leasing scheme, a cross-border deferred-compensation shelter, is the latest example. As a result, both the IRS and Congress are looking to close the loopholes and tighten the definitions in existing rules and legislation governing the practice of employee leasing.

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