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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 301 and 602

[TD 9768]

RIN 1545-BN20

Certified Professional Employer Organizations; Final and Temporary Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to certified professional employer organizations (CPEOs). The Stephen Beck, Jr., Achieving a Better Life Experience Act of 2014 requires the IRS to establish a voluntary certification program for professional employer organizations. These final and temporary regulations contain the requirements a person must satisfy in order to become and remain a CPEO. The final and temporary regulations will affect persons that apply to be CPEOs and are certified by the IRS as meeting the applicable requirements. The text of these final and temporary regulations also serves, in part, as the text of the proposed regulations (REG-127561-15) set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register**.

DATES: Effective Date: These final and temporary regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability Date: For date of applicability, see §301.7705-2T(o).

FOR FURTHER INFORMATION CONTACT: Melissa L. Duce at (202) 317-6798 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these regulations have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545-2266.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

For further information concerning this collection of information, where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referenced notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Overview

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. 113-295), added new sections 3511 and 7705 to the Internal Revenue Code (Code) relating to the federal employment tax¹ consequences and certification requirements, respectively, of a certified professional employer organization (CPEO). The ABLE Act requires the IRS to establish a voluntary program for persons to apply to become certified as a CPEO. This document contains temporary regulations under section 7705 that, together with a forthcoming revenue procedure that will be published in the Internal Revenue Bulletin, describe the application process and certification requirements necessary for a person to become and remain a CPEO.

The temporary regulations in this document apply on and after July 1, 2016, the date the IRS will begin accepting applications for CPEO certification. These temporary regulations, along with the forthcoming revenue procedure and the application forms and instructions that the IRS plans to release before July 1, 2016, provide guidance to enable persons that wish to apply to become CPEOs to prepare and submit applications on and after July 1, 2016, and to enable the IRS to begin processing these applications and make determinations as to whether to approve or deny certification.

Proposed regulations published elsewhere in this issue of the **Federal Register** provide general guidance regarding the federal employment tax consequences under section 3511 for persons certified as CPEOs and their customers, as well as certain definitions under section 7705 that are necessary to implement section 3511. The proposed regulations also propose to adopt the temporary regulations in this document by cross-reference.

¹ For purposes of this preamble, “federal employment taxes” refers to taxes imposed under subtitle C of the Code.

The regulations have been divided, as described, into temporary regulations and proposed regulations in order to balance the interest in considering public comments on rules before they apply with the desire to provide guidance on application procedures that is effective early enough to open the application process and implement the statutory provisions.

The forthcoming revenue procedure will prescribe the specifics of the application process for a person to become a CPEO. In the future, the IRS intends to release another revenue procedure that prescribes the ongoing requirements that CPEOs must meet to maintain certification and describes the consequences of the failure to meet the ongoing requirements.

Professional Employer Organizations

A professional employer organization (PEO), sometimes referred to as an employee leasing company, enters into an agreement with a client to perform some or all of the federal employment tax withholding, reporting, and payment functions related to workers performing services for the client. The terms of a PEO arrangement typically provide that the PEO is the employer (or “co-employer”) of the client’s employees and is responsible for paying the employees and for the related federal employment tax compliance. A PEO also may manage human resources, employee benefits, workers compensation claims, and unemployment insurance claims for the client. The client typically pays the PEO a fee based on payroll costs plus an additional amount. In most cases, however, the employees working in the client’s business are the common law employees of the client for federal tax purposes, and the client is therefore legally responsible for federal employment tax compliance.

The ABLE Act of 2014

The ABLE Act requires the IRS to establish a voluntary certification program for persons to become CPEOs. Section 7705 provides a framework for the IRS to establish such a program. Section 7705(a) defines a CPEO as a person who applies to be treated as a CPEO for purposes of section 3511 and has been certified by the Secretary as meeting the requirements of section 7705(b). Being certified as a CPEO has certain federal employment tax consequences under section 3511 that are described in the proposed regulations under that section published in the Proposed Rules section in this issue of the **Federal Register**.

Section 7705(b) sets forth the certification requirements that a person must satisfy in order to become a CPEO. Under the statute, a person meets the requirements of section 7705(b) if: (1) the person (and any owner, officer, and other person as may be specified in regulations) demonstrates that it meets such requirements as the Secretary shall establish, including requirements relating to tax status, background, experience, business location, and annual financial audits; (2) agrees to satisfy certain bond and financial review requirements; (3) agrees to satisfy reporting requirements imposed by the Secretary; (4) computes its taxable income using an accrual method of accounting unless the Secretary approves another method; (5) agrees to verify on such periodic basis as the Secretary may prescribe that it continues to meet the certification requirements; and (6) agrees to notify the Secretary in writing (within such time as the Secretary may prescribe) of any change that materially affects the continuing accuracy of any agreement or information that was previously made or provided to the IRS in order to meet the certification requirements.

Section 7705(c) prescribes bond and independent financial review requirements that a person must satisfy in order to become and remain a CPEO. To meet these requirements, section 7705(c)(2) provides that a CPEO must post a bond for the payment of federal employment taxes (in a form acceptable to the Secretary) that is in an amount at least equal to a specified amount. This specified amount is, for the period beginning on April 1 of any calendar year through March 31 of the following calendar year, the greater of five percent of the CPEO's liability under section 3511 in the preceding calendar year (but not more than \$1,000,000) or \$50,000.

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 certified public accountant (CPA) as to whether the CPEO's financial statements are presented fairly in accordance with generally accepted accounting principles (GAAP). Section 7705(c)(6) states that the audit date for these purposes is six months after the completion of the CPEO's fiscal year.

Section 7705(c)(3)(B) requires a CPEO to provide to the Secretary, by the last day of the second month beginning after the end of each calendar quarter, an assertion that the CPEO has withheld and made deposits of all federal employment taxes (other than Federal Unemployment Tax Act (FUTA) taxes under chapter 23 of the Code) and an examination level attestation from an independent CPA that states this assertion is fairly stated in all material respects.

Section 7705(d) gives the Secretary the authority to suspend or revoke the certification of any person for purposes of section 3511 if the Secretary determines that

such person is not satisfying the agreements or requirements of sections 7705(b) or (c), or fails to satisfy applicable accounting, reporting, payment, or deposit requirements.

Section 7705(f) provides that the Secretary shall make available to the public the name and address of each person certified as a CPEO and each person whose certification is suspended or revoked.

November 2015 IRS Request for Information on PEO Industry Practices

In an effort to streamline the implementation of a new federal CPEO program and better understand the potential impact of such a program on the PEO industry, on November 17, 2015, the IRS requested information from the public regarding certain PEO industry practices. See IRS News Release IR-2015-127. In particular, the IRS requested information on current PEO industry practices relating to financial audits, verification of payroll tax obligations, working capital and net worth requirements, and covered employees. In response to the IRS request for information, the IRS received comments from seven taxpayers, which were considered in developing the temporary regulations.

Explanation of Provisions

1. Applicable Definitions

The temporary regulations define a CPEO as a person that applies to be certified as a CPEO in accordance with the temporary regulations and has been certified by the IRS as meeting the requirements under those regulations. Consistent with section 7705(b), most of the requirements in these temporary regulations apply both to persons that have been certified as CPEOs and to any person that has applied to be certified

and whose application for certification is pending with the IRS (referred to in the temporary regulations as “CPEO applicants”).

Section 7705(b)(1) provides that the Secretary may establish requirements for certification that apply not only to the CPEO applicant or CPEO, but also to “any owner, officer, and other persons as may be specified in regulations.” Accordingly, the temporary regulations contain a number of requirements that apply to certain owners, officers, and other individuals (referred to in the regulations as “responsible individuals”), as well as certain persons that are related to the CPEO (referred to as “related entities” and “precursor entities”). The remainder of this section 1 of the preamble explains the definitions of these categories of persons.

a. Responsible individual

The temporary regulations generally define a responsible individual as an individual in any of the following categories with respect to the CPEO applicant or CPEO: (1) certain owners; (2) directors and officers; (3) individuals with ultimate responsibility for implementing the decisions of the organization’s governing body; (4) individuals with ultimate responsibility for the organization’s management and operations; (5) individuals with ultimate responsibility for managing the organization’s finances; (6) managing members or general partners; (7) the sole proprietor of a sole proprietorship; and (8) any other individuals with primary responsibility for federal employment tax compliance of the organization.

With respect to determining whether an individual is a responsible individual by reason of ownership, the temporary regulations specify that, in the case of a CPEO applicant or CPEO that is a corporation, a responsible individual includes any individual

who owns 33 percent or more of the total combined voting power of all classes of stock of the corporation entitled to vote or the total value of shares of all classes of stock of the corporation. In the case of a CPEO applicant or CPEO that is a partnership (defined in the temporary regulations as a business entity that is classified as a partnership for federal tax purposes under §§301.7701-1, 301.7701-2, and 301.7701-3), a responsible individual includes any individual who owns 33 percent or more of the profits interest or capital interest in the partnership. In both cases, ownership may be direct or indirect and is determined by applying the constructive ownership rules of section 1563(e) with respect to stock ownership and by substituting the term “interest” for the term “stock” and the term “partnership” for the term “corporation” used in that section, as appropriate for purposes of determining whether an interest in a partnership is indirectly owned by any person. The Department of the Treasury (Treasury Department) and the IRS request comments regarding the administrability of applying the definition of responsible individual with respect to ownership of profits interests in a partnership, the value of which may fluctuate over time.

With respect to directors and officers of the CPEO applicant or CPEO, the temporary regulations provide that a director is any voting member of the governing body (such as the board of directors). An officer is determined by reference to the organization’s organizing document, bylaws, or resolutions, or is otherwise designated consistent with state law (and often includes an organization’s president, vice-president, treasurer, and secretary).

The temporary regulations also provide that a responsible individual includes any individual who, regardless of title, has ultimate responsibility for: (1) implementing the

decisions of the organization's governing body (typically, the chief executive officer (CEO), executive director, or president); (2) supervising the management, administration, or operation of the organization (typically, the chief operating officer (COO)); or (3) managing the organization's finances (typically, the chief financial officer (CFO) or treasurer). Any individual who serves with the titles of executive director, president, CEO, COO, CFO, or treasurer will be considered to have the ultimate responsibilities that are consistent with that title. The temporary regulations also provide that an individual with this ultimate responsibility may include an individual who is not treated as an employee of the CPEO applicant or CPEO.

b. Related entity

The temporary regulations define a related entity of a CPEO applicant or CPEO as including any person that is a member of a controlled group (within the meaning of sections 414(b) and (c) and the regulations thereunder, with two adjustments) of which the CPEO is also a member. Section 414(b) incorporates by reference the controlled group definitions in section 1563. Likewise, the regulations prescribed under section 414(c) -- §§1.414(c)-2 and 1.414(c)-3 -- rely on principles that are substantially similar to the controlled group definitions in section 1563. However, with respect to persons that are not providers of employment-related services, the temporary regulations substitute "more than 50 percent" for "at least 80 percent" in each place the term appears in section 1563(a) and §1.414(c)-2. For persons that are providers of employment-related services, the temporary regulations substitute "more than 5 percent" for "at least 80 percent" in each place the term appears in section 1563(a) and §1.414(c)-2. The temporary regulations define a provider of employment-related services as a person

that provides payroll or other employment tax administration and compliance services to clients, including, but not limited to, collecting, reporting, and paying employment taxes with respect to wages or compensation paid by the provider of employment-related services to individuals performing services for the clients. A provider of employment-related services includes, but is not limited to, a PEO and a CPEO.

A related entity of a CPEO applicant or CPEO also includes any provider of employment-related services if a majority of the directors or a majority of the officers of the CPEO applicant or CPEO are also directors or officers, respectively, of the provider of employment-related services. Finally, a related entity includes any provider of employment-related services with an owner who is a responsible individual of both the provider of employment-related services and the CPEO applicant or CPEO by virtue of the individual's ownership percentage.

c. Precursor entity

The temporary regulations generally define a precursor entity as including any related entity of a CPEO applicant that is or was a provider of employment-related services and has ceased operations, dissolved, or made a substantial asset transfer to the CPEO applicant during the calendar year that the CPEO applicant applies for certification or any of the three preceding calendar years. A precursor entity also includes a related provider of employment-related services that plans to make a substantial asset transfer to the CPEO applicant while the application for certification is pending or in the 12-month period following the date of the CPEO applicant's application.

For this purpose, the temporary regulations define a substantial asset transfer as any transfer of 35 percent or more of the value of the transferor's operating assets, whether through one or a series of transactions and whether accomplished through sale, lease, gift, assignment, succession, merger, consolidation, corporate separation, or any other means. The temporary regulations further provide that operating assets include both tangible and intangible resources related to the conduct of the transferor's trade or business, including but not limited to such intangible assets as contracts, agreements, receivables, employees, and goodwill (which includes the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factors). In the case of a contract described in section 7705(e)(2) or service agreement described in §31.3504-2(b)(2)² with a provider of employment-related services, even if the contract or agreement is not sold, gifted, assigned, or otherwise formally transferred to a CPEO applicant, it will be considered transferred from a person to the CPEO applicant if the person entered into the contract or agreement but the CPEO applicant reports, withholds, or pays, under its employer identification number (EIN), any applicable federal employment taxes with respect to the wages of any individuals covered by the contract or agreement.

Finally, the temporary regulations contain a rule for purposes of determining whether a provider of employment-related services that has ceased operations, dissolved, or made a substantial asset transfer to a CPEO applicant is a related entity of

² A service agreement described in §31.3504-2(b)(2) is a written or oral agreement pursuant to which the payor: (1) asserts it is the employer (or "co-employer") of individuals performing services for the client; (2) pays wages or compensation to the individuals for services the individuals perform for the client; and (3) assumes responsibility to collect, report, and pay, or assumes liability for, any employment taxes with respect to the wages or compensation paid by the payor to the individuals performing services for the client.

the CPEO applicant. Specifically, the provider of employment-related services is a related entity of a CPEO applicant if it would be or would have been a related entity of the CPEO applicant as described in section 1.b of the preamble at the time of the provider's ceasing of operations, dissolution, or substantial asset transfer, as applicable. This determination is based on the provider's ownership and responsible individuals at the time of its ceasing of operations, dissolution, or substantial asset transfer, as applicable, and the ownership and responsible individuals of the CPEO applicant at the time of its application.

2. Application Process and Effective Date of Certification

The temporary regulations provide that in order to be certified, a CPEO applicant must submit a properly completed and executed application to the IRS. In addition, the CPEO applicant's responsible individuals must also submit the information required by the regulations and in further guidance.

The IRS will notify the CPEO applicant as to whether its application for certification has been approved or denied and the effective date of its certification. If the IRS denies the application, the IRS will inform the CPEO applicant of the reason(s) for denial. The temporary regulations also state that if the IRS approves a CPEO applicant's application for certification, the IRS will make available to the public the name and address of the CPEO, as well as the effective date of its certification.

3. Requirements for Certification

Section 7705(b)(1) provides that, to become and remain certified as a CPEO,³ a person, as well as any owner, officer, or other person specified in regulations (which, in the temporary regulations, is any responsible individual, related entity, or precursor entity), must meet such requirements as the Secretary shall establish in order for the person to be certified, including requirements with respect to tax status, background, experience, business location, and annual financial audits. The temporary regulations elaborate upon the requirements that a CPEO applicant and CPEO must meet in each of these categories to become and remain certified.

The temporary regulations provide that the IRS may deny a CPEO applicant's application for certification or revoke or suspend a CPEO's certification if a CPEO applicant or CPEO, or any of the precursor entities, related entities, or responsible individuals of the CPEO applicant or CPEO, fails to meet any applicable requirement described in the regulations or other applicable guidance. The temporary regulations also provide that the IRS will deny a CPEO applicant's application for certification or revoke or suspend a CPEO's certification if the IRS determines, in its sole discretion, that such failure presents a material risk to the IRS's collection of federal employment taxes. In determining whether one or more failures to meet the requirements described in the regulations presents a material risk to the IRS's collection of federal employment

³ Section 7705(a)(1) provides that a person must be certified by the Secretary as meeting the requirements of section 7705(b) to become certified as a CPEO, and section 7705(b)(5) provides that the person must agree to verify that it continues to meet the requirements of section 7705(b) on such periodic basis as the Secretary may prescribe. In addition, section 7705(d) provides that the Secretary may suspend or revoke a certification of any person if the Secretary determines that such person is not satisfying the agreements or requirements of section 7705(b) (including the CPEO's agreement to verify that it continues to meet the requirements of section 7705(b) that it makes pursuant to section 7705(b)(5)).

taxes, the IRS will generally consider all relevant facts and circumstances, including the size, scope, nature, significance, recurrence, and timing of and reason for the failure(s), and, in the case of a CPEO, any prior failures of the CPEO to meet the requirements of this section.

a. Suitability

The Treasury Department and the IRS view tax compliance of the CPEO applicant or CPEO, and of its responsible individuals, related entities, and precursor entities, as an important factor in determining whether the CPEO applicant's or the CPEO's certification presents a material risk to the IRS's collection of federal employment taxes. Therefore, the temporary regulations provide that the IRS may deny an application for certification, or suspend or revoke a CPEO's certification, if the CPEO applicant or CPEO, or any of its precursor entities, related entities, or responsible individuals, has failed to pay any applicable federal, state, or local taxes or file any required federal, state, or local tax or information returns in a timely and accurate manner, unless the failure to file or failure to pay is determined to be due to reasonable cause and not to willful neglect. In addition, the temporary regulations provide that a CPEO must be a business entity described in §301.7701-2(a) except that it may not be a disregarded entity 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 purposes). Under §301.7701-2(a), a business entity is any entity recognized for federal tax purposes that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Code.

The Treasury Department and the IRS consider the criminal background of a CPEO applicant or CPEO and its responsible individuals to present a material risk to tax compliance and, therefore, the absence of such criminal background is another important requirement for certification. Consistent with section 7705(b)(1), which includes background as a category with respect to which the IRS may establish requirements for certification, the temporary regulations state that the IRS may deny an application for certification, or suspend or revoke a CPEO's certification, if the CPEO applicant or CPEO, or any of its precursor entities, related entities, or responsible individuals, has been charged or convicted of any criminal offense under the laws of the United States or of a state or political subdivision thereof, or is the subject of an active IRS criminal investigation. This is also consistent with suggestions made by the Joint Committee on Taxation, which noted that the regulations under section 7705(b)(1) could include requirements for favorable criminal background checks. See Staff of the Joint Committee on Taxation (JCS), General Explanation of Tax Legislation Enacted in the 113th Congress, JCS-1-15, at 233 (March 2015) (General Explanation). Additionally, the IRS may consider whether the CPEO applicant or CPEO, or any precursor entities, related entities, or responsible individuals of the CPEO applicant or CPEO, is listed on any sanctions list compiled by the Office of Foreign Assets Control (OFAC) within the Department of Treasury, including but not limited to the OFAC Consolidated Sanctions List and the OFAC Specially Designated Nationals (SDN) List.

The temporary regulations further state, consistent with section 7705(b)(1), that the IRS may deny a CPEO applicant's application for certification, or suspend or revoke a CPEO's certification, if the CPEO applicant or CPEO, or any of its precursor entities,

related entities, or responsible individuals, has been sanctioned or had a license, registration, or accreditation (including a license, registration, or accreditation relating to its status or ability to operate as a PEO) denied, suspended, or revoked by a court of competent jurisdiction, licensing board, assurance or other professional organization, or federal or state agency, court, body, board, or other authority for any misconduct that bears upon the suitability of the CPEO applicant or CPEO to perform its professional functions. Such misconduct may relate to dishonesty, fraud, or breach of trust and would include any criminal or civil penalties for violating any state laws prohibiting the transfer or acquisition of a business solely or primarily for the purpose of obtaining a lower unemployment tax rate or avoiding a higher unemployment tax rate.

In addition, the temporary regulations provide that the IRS may deny a CPEO applicant's application for certification, or revoke or suspend a CPEO's certification, if the CPEO applicant or CPEO, or any of its precursor entities, related entities, or responsible individuals, fails to demonstrate a history of financial responsibility, which the IRS may assess through checks on credit history and other similar indicators.

With respect to the requirements relating to experience referred to in section 7705(b)(1), the Treasury Department and the IRS consider it important that a CPEO applicant or CPEO be managed by individuals with knowledge or experience regarding federal and state employment tax compliance and business practices relating to those compliance requirements. This is consistent with the suggestions made by the Joint Committee on Taxation. See General Explanation at 233. The temporary regulations provide that the IRS may deny a CPEO applicant's application for certification or revoke or suspend a CPEO's certification if the CPEO applicant or CPEO and its responsible

individuals fail to demonstrate adequate collective knowledge or experience with respect to federal or state employment tax reporting, depositing, and withholding requirements; handling and accounting of payroll, tax payments, and other funds on behalf of others; effective recordkeeping systems; retention of qualified personnel and legal advisors; and general business and risk management.

The temporary regulations provide that the IRS may deny a CPEO applicant's application for certification, or revoke or suspend a CPEO's certification, if the CPEO applicant or CPEO, or any of its responsible individuals, gives false or misleading information (including by intentionally omitting relevant information) or participates in any way in the giving of false or misleading information, to the IRS, knowing, or having reason to know, the information to be false or misleading. For these purposes, the term "information" includes: facts or other matters contained in testimony, federal tax returns, and financial statements and opinions regarding such statements; applications for certification (and all accompanying documentation); affidavits, declarations, assertions, attestations, statements, and agreements; periodic verifications that the requirements of this section continue to be met; and any other information that is required to be provided by these temporary regulations, section 3511 and the regulations thereunder, or further guidance.

In order to confirm the accuracy of information provided to the IRS with respect to these requirements, the temporary regulations require the CPEO applicant or CPEO, and each of its responsible individuals, to take such actions as are necessary to authorize the IRS to investigate the accuracy of statements and submissions made by the CPEO applicant or CPEO, including waiving confidentiality and privilege when

necessary, and to conduct comprehensive background checks, including, but not limited to, checks on tax compliance, criminal background, professional experience (including through the contact of third-party references), credit history, and professional sanctions. In addition, each responsible individual of a CPEO applicant or CPEO must submit fingerprints in the time and manner and under the circumstances prescribed by the Commissioner in further guidance. The IRS is considering whether to expand the category of individuals who must authorize the IRS to conduct comprehensive background checks and submit fingerprint cards to include certain directors, officers, and owners of a CPEO applicant's or CPEO's related entities. Treasury and the IRS request comments regarding such possible expansion, including how any such expansion could be as administrable as possible. To submit comments, please follow the instructions in the "Comments and Requests for Public Hearing" section in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register**.

b. Business location

Section 7705(b)(1) specifically lists business location as one of the categories of certification requirements that the Secretary may establish. The temporary regulations require a CPEO applicant or CPEO to have one or more established physical business locations in the United States at which regular operations that constitute a trade or business within the United States (within the meaning of section 864(b)) take place and at which a significant portion of its CPEO-related functions are carried on and the

administrative records relating to those functions are kept.⁴ The temporary regulations also require the CPEO applicant or CPEO to be created or organized in the United States or under the law of the United States or of any state. The temporary regulations further require that a majority of the CPEO applicant's or CPEO's responsible individuals be citizens or residents of the United States. Finally, a CPEO applicant or CPEO must use only financial institutions described in section 265(b)(5) to hold its cash and cash equivalents, receive payments from customers, and pay wages and federal employment taxes. Under section 265(b)(5), a financial institution is, among other requirements, a person who is subject to federal or state supervision as a financial institution or a bank or trust company that is subject to supervision and examination by state or federal authority having supervision over banking institutions.

c. Financial statements

In addition to the specific requirements with respect to financial statements in section 7705(c), section 7705(b)(1) provides that the Secretary may establish requirements with respect to annual financial audits. Pursuant to these provisions, the temporary regulations 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. 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 this fiscal year has not yet been completed at the time of application, a CPEO applicant must also provide

⁴ This requirement is consistent with the General Explanation, which provides that "the existence of an established business location within the United States at which significant operations regularly take place" is a business location requirement that the Secretary could impose. General Explanation, at 234.

to the IRS a copy of its audited financial statements for the immediately preceding fiscal year, if any. The temporary regulations provide that the CPEO applicant must subsequently provide to the IRS the financial statements for the most recently completed fiscal year by the last day of the sixth month after such fiscal year ends. In addition, for any fiscal year that ends after the CPEO applicant applies for certification and on or before the effective date of certification, if applicable, the CPEO applicant must provide the audited financial statements by the last day of the sixth month after such fiscal year ends. The obligation to provide the audited financial statements described in the preceding sentence continues to apply after the CPEO applicant is certified as a CPEO. Once certified, pursuant to section 7705(b)(1), a CPEO is required by the temporary regulations to provide a copy of its annual audited financial statements to the IRS within six months of the end of each fiscal year (beginning with the first fiscal year that ends after the CPEO's effective date of certification). For these purposes, a CPEO applicant's or CPEO's fiscal year will be considered completed once the last day of that fiscal year has ended, even if the CPEO was not operating or certified for the full fiscal year or the fiscal year was a short year consisting of fewer than 12 months.

Additionally, the Treasury Department and the IRS believe a CPEO with annual audited financial statements that reflect positive working capital (as determined in accordance with GAAP) presents 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 PEO certification and registration laws, the temporary regulations require a CPEO applicant or CPEO to cause to be prepared and provided to the IRS, by the same date it must provide a copy

of its annual audited financial statements, an opinion of an independent CPA that such financial statements reflect positive working capital for the fiscal year, unless the exception described in the next paragraph applies. 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. Consistent with section 7705(c)(3)(A), this CPA opinion must also generally state that the financial statements are presented fairly in accordance with GAAP.

The Treasury Department and the IRS recognize that working capital may fluctuate over the course of a CPEO's fiscal year due to normal business operations. To allow for some fluctuation in working capital, the temporary regulations contain an exception to the positive working capital requirement. Under this exception, a CPEO applicant or CPEO will not fail to meet the positive working capital requirement if three requirements are satisfied. First, the CPEO applicant or CPEO must have negative working capital for no more than two consecutive fiscal quarters of that fiscal year (as demonstrated by the financial statements for the final fiscal quarter of the fiscal year or the quarterly statements described in this section 3.c of the preamble for any other fiscal quarter). Second, the CPEO applicant or CPEO or its CPA must provide an explanation to the IRS describing the reason for the failure in such time and manner as the Commissioner may prescribe in further guidance. Third, the IRS must determine, in its sole discretion, that the failure does not present a material risk to the IRS's collection of federal employment taxes.

The temporary regulations provide special rules for newly established CPEO applicants. A CPEO applicant that was not operating as a provider of employment-

related services for all or part of the most recently completed fiscal year as of the date it applies for certification must also provide a copy of the audited financial statements of any precursor entity for the precursor entity's most recently completed fiscal year as of the date of the application for certification, as well as a CPA opinion that these financial statements demonstrate positive working capital and are presented fairly in accordance with GAAP. The financial statements and CPA opinion for a precursor entity must be provided in such time and manner as the Commissioner may prescribe in further guidance.

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, the temporary regulations require a CPA to be independent as prescribed by the American Institute of Certified Public Accountants' Professional Standards, Code of Professional Conduct, and its interpretations and rulings. The Treasury Department and the IRS request comments regarding whether the CPA independence guidelines or requirements of other governmental agencies or departments or industry self-regulatory bodies, as adapted for a CPA of a CPEO, would better ensure the impartiality of CPAs providing opinions on CPEO's financial statements, such as: (1) the Department of Labor's guidelines on the independence of CPAs retained by employee benefit plans under 29 CFR 2509.75-9; (2) the Securities and Exchange Commission's (SEC) independence guidelines for auditors reporting on financial statements included in SEC filings; and (3) the Government Accountability Office's auditor independence requirements under

Government Auditing Standards that cover federal entities and organizations receiving federal funds.

As previously noted, section 7705(b)(5) requires a CPEO to verify on a periodic basis that it meets certification requirements. In accordance with this requirement and pursuant to the Secretary's general authority under section 7705(b)(1) to establish requirements for CPEOs to become and remain certified, the temporary regulations further require a responsible individual of the CPEO applicant or the CPEO to provide, by the last day of the second month after the end of each calendar quarter and beginning with the most recently completed quarter as of the date of the application for certification, a statement verifying under penalties of perjury that the CPEO applicant or the CPEO has positive working capital with respect to the most recently completed fiscal quarter. However, as with the requirement that annual financial statements reflect positive working capital, the temporary regulations also contain an exception to this requirement. The exception applies only if the CPEO does not have negative working capital at the end of the two fiscal quarters immediately preceding the fiscal quarter to which the statement relates. As with the exception provided with respect to annual financial statements that reflect negative working capital, the CPEO must also provide an explanation to the IRS describing the reason for the failure in such time and manner as the Commissioner may prescribe in further guidance, and the IRS must determine, in its sole discretion, that the failure does not present a material risk to the IRS's collection of federal employment taxes.

d. Quarterly assertion and attestation

Section 7705(c)(3)(B) requires a CPEO to provide to the Secretary an assertion and examination level attestation regarding its compliance with federal employment tax withholding and depositing requirements. In accordance with this provision, the temporary regulations state that a CPEO must provide, on a quarterly basis and beginning with the first calendar quarter that ends after the CPEO's effective date of certification, an assertion signed by a responsible individual under penalties of perjury stating that the CPEO has withheld and made deposits of all federal employment taxes (other than taxes imposed by chapter 23 of the Code) as required for the quarter.⁵ In addition, the CPEO must provide an examination level attestation from a CPA stating that this assertion is fairly stated. The assertion and attestation must be provided by the last day of the second month after the end of each calendar quarter. These quarterly assertion and attestation requirements also apply to a CPEO applicant, who must provide the required assertion and attestation for the most recently completed calendar quarter as of the date of its application for certification and each subsequent calendar quarter while its application is pending. A CPEO applicant that was not operating as a provider of employment-related services during the most recently completed calendar quarter as of the date of its application for certification or during any quarter that ends while its application for certification is pending must provide an assertion and attestation for any precursor entity in such time and manner as the Commissioner may prescribe in further guidance.

⁵ Although the temporary regulations (and section 7705(c)(3)(B)) do not require the assertion to include a statement with respect to taxes imposed by chapter 23 of Code, the IRS expects to evaluate compliance with deposit requirements with respect to taxes imposed by chapter 23 through tax compliance checks.

The temporary regulations provide that a CPEO applicant or CPEO will not fail to meet the quarterly assertion and attestation requirements if the CPA examination level attestation indicates that the CPEO applicant or CPEO has failed to withhold or make deposits in certain immaterial respects, provided that the attestation includes a summary of the immaterial failures that were found and states that the failures were immaterial and isolated and do not reflect a meaningful lapse in compliance with federal employment tax withholding and deposit requirements. Furthermore, in order for this exception for immaterial failures to apply, the IRS must determine, in its sole discretion, that the isolated and immaterial failures identified by the CPA do not present a material risk to the IRS's collection of federal employment taxes.

e. Bond requirements

Section 7705(c)(2) sets forth the bond requirements that a person must satisfy in order to become and remain a CPEO. The provisions of section 7101 and its accompanying regulations apply to bonds required by section 7705(c)(2), except to the extent modified in the temporary regulations. The temporary regulations provide that a CPEO must post a bond for the payment of federal employment taxes in a specified amount. This specified amount is, for each period beginning on April 1 of any calendar year (or, in the case of a newly certified CPEO, on the effective date of certification) and ending on March 31 of the following calendar year (the bond period), an amount that is at least equal to the greater of: (1) five percent of the CPEO's liability under section 3511 (or, if applicable, the liability as determined for newly certified CPEOs, discussed in section 3.e.i of this preamble) during the calendar year preceding the bond period, but not more than \$1,000,000; or (2) \$50,000. The proposed regulations require the

bond to be issued by a surety company that holds a certificate of authority from the Secretary as an acceptable surety on federal bonds and meets such other requirements as the Commissioner may prescribe in further guidance.

One benefit of the bond requirement in section 7705(c) is that the CPEO must submit to the bonding surety's financial underwriting process to obtain the bond, which provides the IRS with a certain level of assurance concerning the financial condition of the CPEO. The Treasury Department and the IRS believe that this benefit is substantially diminished if the CPEO obtains the bond by posting collateral in the amount of the bond. For this reason, the temporary regulations provide that the CPEO must meet the bond requirements without posting collateral.

i. Calculating Five Percent of Liability under Section 3511

In calculating five percent of its liability under section 3511 (or, if applicable, the liability described in the subsequent paragraph) during the preceding calendar year, the temporary regulations require that a CPEO base its calculation on the amount of applicable federal employment taxes⁶ it reported and paid in the preceding calendar year. However, if the CPEO or the IRS subsequently determines that the applicable federal employment tax liability for the preceding calendar year was higher than the amount reported and paid (and makes an adjustment or assessment, respectively, reflecting that determination), and if the bond that the CPEO had posted was less than \$1,000,000, the CPEO must post a strengthening bond that, together with the initially-posted bond, equals a total amount that reflects the adjusted applicable federal

⁶ As noted in the Background section of this preamble, the term "federal employment taxes" includes all taxes imposed under Subtitle C of the Code, including income tax withholding and FICA, RRTA, and FUTA taxes. As such, the liability described in this paragraph is based on an amount that includes both the employee and employer shares of FICA and RRTA, as well as income tax withholding and FUTA.

employment tax liability up to \$1,000,000. Alternatively, the CPEO could post a superseding bond in such an adjusted amount.

A newly certified CPEO will not have any liability under section 3511 for the calendar year preceding its certification on which to base its calculation of the required bond amount. In such cases, the temporary regulations provide that, in calculating the bond amount, the liability used for the preceding calendar year (or portion thereof⁷) when the CPEO was not certified is the federal employment tax liability of the CPEO⁸ and of any precursor entity of the CPEO that made a substantial asset transfer to the CPEO, that results from one or more service agreements described in §31.3504-2(b)(2). In determining the federal employment tax liability of a precursor entity of a CPEO for a preceding year, only liability amounts that resulted from service agreements that were transferred or are intended to be transferred to the CPEO (at the time that the amount of the bond is determined) are included. If no such precursor entity exists and the CPEO otherwise had no federal employment tax liability during the preceding calendar year, the amount of the bond will be \$50,000.

ii. Cancellation

The temporary regulations provide that the bond posted by a CPEO must provide that it may be cancelled by the surety only after the surety gives written notice to the IRS and the CPEO. (See Form 14751, “Certified Professional Employer Organization Surety Bond,” for details on the time and manner in which such written notice must be provided.) The bond must also provide that, if the surety cancels the bond without

⁷ Unless the CPEO is certified effective January 1, the CPEO will not have liability under section 3511 for the portion of the calendar year in which it was certified that preceded its certification.

⁸ For purposes of this paragraph, the term “CPEO” is intended to include the CPEO before it applied for certification and while its application for certification was pending.

issuing a superseding bond to the CPEO, the surety will remain liable for all federal employment tax liability accrued by the CPEO during the period beginning with the effective date of the first bond issued by the surety to the CPEO in any consecutive series of bonds issued by that surety prior to cancellation and ending with the cancellation (the total bond period), up to the penal amount of the bond at the time of cancellation. The temporary regulations provide that a cancelling surety will remain liable for federal employment tax liability accrued during the total bond period up to the penal amount of the bond for as long as the Commissioner may assess and collect taxes for such period under sections 6501 and 6502.

4. Controlled Groups

The temporary regulations provide that CPEO applicants and CPEOs that are members of a controlled group, within the meaning of sections 414(b) and (c), will be treated as a single CPEO applicant or CPEO for purposes of the financial statement, quarterly assertion and attestation, and bond requirements described in this preamble, except that the annual and quarterly requirements imposed under the scope of sections 7705(b)(1) and 7705(b)(5) with respect to positive working capital apply to each CPEO applicant or CPEO on a separate basis.

5. Consents to Disclose

In order to receive and maintain certification, the temporary regulations state that a CPEO applicant or CPEO must provide such consents for the IRS to disclose confidential tax information to its customers, and to other persons as necessary to carry out the purposes of these regulations, that relates to its certification and obligations to

report, deposit, and pay federal employment taxes as the Commissioner may require in further guidance.

6. Periodic Verification and Notification of Material Changes

Consistent with section 7705(b)(5), the temporary regulations require a CPEO to verify periodically that it continues to meet the certification requirements in such time and manner as the Commissioner may prescribe in further guidance. Consistent with section 7705(b)(6), the temporary regulations provide that a CPEO applicant or CPEO must notify the IRS, in the time and manner prescribed by the Commissioner in further guidance, of any change that materially affects the continuing accuracy of any agreement or information that was previously made or provided to the IRS. The Treasury Department and the IRS expect to provide further details regarding these requirements in a future revenue procedure that will prescribe the ongoing requirements that CPEOs must meet to maintain certification.

7. Accrual Method of Accounting

Consistent with section 7705(b)(4), the temporary regulations require a CPEO to compute its taxable income using an accrual method of accounting or, if applicable, another method that the Commissioner prescribes in further guidance.

8. Compliance with Reporting Obligations

The temporary regulations provide that a CPEO must make reports to the IRS and to its clients as provided in section 3511(g) and regulations issued thereunder. This includes the filing of all federal employment tax and information returns. The temporary regulations also require a CPEO to file all returns, schedules, reports, and other forms and documents on magnetic media when required to do so by section 3511(g) and

regulations issued thereunder, or by other Treasury regulations. With respect specifically to the requirement that CPEOs file Form 940, "Employer's Annual Federal Unemployment (FUTA) Tax Return," and Form 941, "Employer's QUARTERLY Federal Tax Return," on magnetic media, compliance with this requirement is a condition of certification. The CPEO program is a voluntary certification regime; a person that does not wish to file Forms 940 and 941 on magnetic media is not obligated to apply for or obtain certification as a CPEO.

9. Suspension and Revocation

The temporary regulations provide that the IRS may suspend or revoke the certification of any CPEO as a result of a failure to meet any of the requirements for CPEOs, and the IRS will suspend or revoke certification if the IRS determines, in its sole discretion, that such failure presents a material risk to the IRS's collection of federal employment taxes. If a CPEO's certification is suspended, section 3511 will not apply to any contract described in section 7705(e)(2) into which the CPEO enters during the suspension period. If a CPEO's certification is revoked, the organization will not be considered a CPEO for purposes of section 3511 after the effective date of such revocation unless and until it again applies and is again certified as a CPEO. However, an organization whose certification as a CPEO has been revoked may not re-apply to be certified as a CPEO until one year has passed since the effective date of its revocation. Neither the suspension nor the revocation of an organization's status as a CPEO will affect its potential liability under §31.3504-2.

The temporary regulations provide that an organization whose certification as a CPEO has been suspended or revoked must notify its customers of the suspension or

revocation (in the time and manner provided in further guidance). In addition, the IRS will make public a CPEO's suspension or revocation and may also individually notify the CPEO's customers of such suspension or revocation.

Effective/Applicability Date

The IRS has announced that it plans to begin accepting applications for CPEO certification on July 1, 2016. Accordingly, the temporary regulations apply on and after July 1, 2016. Pursuant to section 7805(e)(2), the temporary regulations expire on or before May 3, 2019.

Statement of Availability of IRS Documents

IRS revenue procedures, revenue rulings, notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS Web site at <http://www.irs.gov>.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) please refer to the Special Analyses section of the preamble to the cross-referenced notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Melissa Duce, Andrew Holubeck, and Neil Shepherd of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in the development of these regulations.

List of Subjects

26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 301 and 602 are amended as follows:

PART 301--PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 301.7705-1T also issued under 26 U.S.C. 7705(h).

Section 301.7705-2T also issued under 26 U.S.C. 7705(h).

* * * * *

Par. 2. Sections 301.7705-1T and 301.7705-2T are added to read as follows:

§ 301.7705-1T Certified professional employer organization.

(a) Application. The definitions set forth in this section apply for purposes of this section, §301.7705-2T and sections 3302(h), 3303(a)(4), 3511, 6053(c)(8), and 7528(b)(4).

(b) Definitions--(1) Certified professional employer organization (CPEO) means a person that applies to be certified as a CPEO in accordance with §301.7705-2T(a) and has been certified by the Internal Revenue Service (IRS) as meeting the requirements of §301.7705-2T. For purposes of §301.7705-2T(g)(2), the term CPEO also includes the person before it applied for certification and while its application is pending with the IRS. For all other purposes, a person is a CPEO as of the effective date of its certification (as specified in the certification notice described in §301.7705-2T(a)(2)) and until its certification is revoked by the IRS (as described in §301.7705-2T(n)) or, if earlier and applicable, until the CPEO voluntarily terminates its certification in the time and manner prescribed by the Commissioner in further guidance.

(2) CPEO applicant means a person that has applied to be certified as a CPEO in accordance with §301.7705-2T(a) and whose application is pending with the IRS.

(3) CPEO contract. [Reserved]

(4) Certified public accountant (CPA) means a certified public accountant 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 in any state;

(iv) Files 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; and

(v) Meets such other requirements as the Commissioner may prescribe in further guidance.

(5) Covered employee. [Reserved]

(6) Customer. [Reserved]

(7) Federal employment taxes means the taxes imposed by subtitle C of the Internal Revenue Code.

(8) Guidance includes guidance published in the Federal Register or Internal Revenue Bulletin, as well as administrative guidance such as forms, instructions, publications, or other guidance on the IRS.gov Web site.

(9) Partnership means a business entity (as described in §301.7701-2(a)) that is classified as a partnership for federal tax purposes under §§301.7701-1, 301.7701-2, and 301.7701-3. Accordingly, any references to a managing member or general partner of a partnership mean a managing member or general partner of an entity that is classified as a partnership for federal tax purposes.

(10) Precursor entity--(i) In general. A precursor entity means, with respect to a CPEO applicant, any related entity of the CPEO applicant that is or was a provider of employment-related services that--

(A) Has made a substantial asset transfer to the CPEO applicant during the calendar year that the CPEO applicant applies for certification or any of the three preceding calendar years or plans to make such a substantial asset transfer while the

application for certification is pending or in the 12-month period following the date of the CPEO applicant's application for certification; or

(B) Has ceased operations or dissolved during the calendar year that the CPEO applicant applied for certification or any of the three preceding calendar years.

(ii) Related. For purposes of this paragraph (b)(10), a provider of employment-related services is considered a related entity of a CPEO applicant if it is a related entity within the meaning of paragraph (b)(12) of this section or if it would be or would have been such a related entity based on the ownership and responsible individuals of the provider of employment-related services at the time of its substantial asset transfer, ceasing of operations, or dissolution, as applicable, and the ownership and responsible individuals of the CPEO applicant at the time of its application.

(11) Provider of employment-related services means a person that provides employment tax administration, payroll services, or other employment-related compliance services to clients, including, but not limited to, collecting, reporting, and paying employment taxes with respect to wages or compensation paid by the person to individuals performing services for the clients. A provider of employment-related services includes, but is not limited to, a CPEO.

(12) Related entity means, with respect to a CPEO applicant or CPEO, any person that meets one or more of the following criteria:

(i) The person is a member of a controlled group of which the CPEO applicant or CPEO is also a member. For purposes of this paragraph (b)(12)(i), controlled group has the meaning given to such term by sections 414(b) and (c) and the regulations thereunder, except that--

(A) With respect to a person that is not a provider of employment-related services “more than 50 percent” will be substituted for “at least 80 percent” each place it appears in section 1563(a) (which is cross-referenced in section 414(b)) and §1.414(c)-2 of this chapter); and

(B) With respect to a person that is a provider of employment-related services, “more than 5 percent” will be substituted for “at least 80 percent” each place it appears in section 1563(a) and §1.414(c)-2 of this chapter; or

(ii) The person is a provider of employment-related services and--

(A) A majority of the directors or a majority of the officers (as described in paragraph (b)(13)(ii) of this section) of the CPEO applicant or CPEO are directors or officers (as described in paragraph (b)(13)(ii) of this section), respectively, of the provider of employment-related services; or

(B) An individual is a responsible individual of both the provider of employment-related services and the CPEO applicant or CPEO by reason of paragraph (b)(13)(i) of this section.

(13) Responsible individual means, with respect to a CPEO applicant or CPEO, (or, for purposes of paragraphs (b)(10)(ii) or (b)(12)(ii) of this section, a provider of employment-related services), the following individuals:

(i) Any individual who owns, directly or indirectly and applying the constructive ownership rules of section 1563(e) with respect to stock ownership and by substituting the term “interest” for the term “stock” and the term “partnership” for the term “corporation” used in that section, as appropriate for purposes of determining whether an interest in a partnership is indirectly owned by any person, 33 percent or more of--

(A) In the case of a corporation, the total combined voting power of all classes of stock entitled to vote of such corporation or of the total value of shares of all classes of stock of such corporation; or

(B) In the case of a partnership, the capital interest or profits interest of such partnership.

(ii) Any individual who is a director or an officer. For purposes of this paragraph (b)(13)(ii), a director is a voting member of the governing body (that is, the board of directors or equivalent controlling body authorized under state law to make governance decisions on behalf of the organization), and the officers are determined by reference to the organizing document, bylaws, or resolutions of the governing body, or otherwise designated consistent with state law. Officers may include a president, vice-president, secretary, and treasurer.

(iii) Any individual who, regardless of title, has ultimate responsibility for implementing the decisions of the organization's governing body. An individual who serves with the title of chief executive officer, executive director, and/or president has this ultimate responsibility. An individual with this ultimate responsibility may include an individual who is not treated as an employee of the organization. If this ultimate responsibility resides with two or more individuals (for example, co-presidents), who may exercise such responsibility in concert or individually, then each individual is a responsible individual.

(iv) Any individual who, regardless of title, has ultimate responsibility for supervising the management, administration, or operation of the organization. An individual who serves with the title of chief operating officer has this ultimate

responsibility. An individual with this ultimate responsibility may include an individual who is not treated as an employee of the organization. If this ultimate responsibility resides with two or more individuals, who may exercise such responsibility in concert or individually, then each individual is a responsible individual.

(v) Any individual who, regardless of title, has ultimate responsibility for managing the organization's finances. An individual who serves with the title of chief financial officer or treasurer has this ultimate responsibility. An individual with this ultimate responsibility may include an individual who is not treated as an employee of the organization. If this ultimate responsibility resides with two or more individuals who may exercise the responsibility in concert or individually, then each individual is a responsible individual.

(vi) In the case of a partnership, any individual who is a managing member or general partner.

(vii) In the case of a sole proprietorship, the sole proprietor.

(viii) Any other individual with primary responsibility for the organization's federal employment tax compliance.

(14) Self-employed individual. [Reserved]

(15) Substantial asset transfer means any transfer of 35 percent or more of the value of the operating assets of the person making the transfer, whether through one or a series of transactions and whether accomplished through sale, lease, gift, assignment, succession, merger, consolidation, corporate separation, or any other means. For purposes of this paragraph (b)(15), operating assets include both tangible and intangible resources related to the conduct of the person's trade or business,

including but not limited to such intangible assets as contracts, agreements, receivables, employees, and goodwill (which includes the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factors). In the case of a contract described in section 7705(e)(2) or a service agreement described in §31.3504-2(b)(2) of this chapter entered into by a provider of employment-related services, even if the contract or agreement is not sold, gifted, assigned, or otherwise formally transferred to a CPEO applicant, it will be considered transferred from the provider of employment-related services to the CPEO applicant if the CPEO applicant reports, withholds, or pays, under its employer identification number (EIN), any applicable federal employment taxes with respect to the wages of any individuals covered by the contract or agreement.

(c) Effective/applicability date--(1) In general. Except as provided in paragraph (c)(2) of this section, this section applies on and after July 1, 2016.

(2) Definitions related to section 3511. [Reserved]

(3) Expiration date. The applicability of this section expires on or before May 3, 2019.

§301.7705-2T CPEO certification requirements.

(a) Application requirement and certification--(1) Application. To be certified as a certified professional employer organization (CPEO), a person must submit a properly completed and executed application for certification as a CPEO in the time and manner prescribed by, and providing such information as required by, this section and any further guidance issued by the Commissioner. In addition, the applicant's responsible individuals must submit such information as is specified in this section and further guidance.

(2) Notice. A CPEO applicant will be notified by the Internal Revenue Service (IRS) whether its application for certification has been approved or denied, and, if approved, the effective date of certification. If the IRS denies the application, the IRS will inform the CPEO applicant of the reason(s) for denial.

(3) Public disclosure of certification. If the IRS approves a CPEO applicant's application for certification, the IRS will make available to the public the name and address of the CPEO, as well as the effective date of its certification, in the time and manner described in further guidance.

(4) Effective date of certification. A CPEO's certification will be effective as of the effective date of certification specified in the notice described in paragraph (a)(2) of this section and in the public disclosure described in paragraph (a)(3) of this section and will continue in effect until the effective date of the revocation of the CPEO's certification, if any, as described in paragraph (n) of this section or, if earlier, the date that the CPEO voluntarily terminates its certification in the time and manner prescribed by the Commissioner in further guidance.

(b) Requirements for certification. To receive and maintain certification, a CPEO applicant or CPEO must meet the requirements described in this section, as well as any additional requirements the Commissioner may prescribe in further guidance. In addition, any precursor entities, related entities, and responsible individuals (as defined in §§301.7705-1T(b)(10), (12), and (13), respectively) of the CPEO applicant or CPEO must meet any requirements applicable to them described in this section and in further guidance. The IRS may deny an application for certification or revoke or suspend a CPEO's certification if a CPEO applicant or CPEO, or one or more of its precursor

entities, related entities, or responsible individuals, fails to meet any applicable requirement described in this section or other applicable guidance, and the IRS will do so if the IRS determines, in its sole discretion, that such failure presents a material risk to the IRS's collection of federal employment taxes. In determining whether one or more failures to meet the requirements described in this section presents a material risk to the IRS's collection of federal employment taxes, the IRS generally will consider all relevant facts and circumstances, including the size, scope, nature, significance, recurrence, and timing of and reason for the failure and, in the case of a CPEO, any prior failures of the CPEO to meet the requirements of this section.

(c) Suitability--(1) In general. The IRS may deny an application for certification or revoke or suspend a CPEO's certification for any of the following reasons:

(i) The CPEO applicant or CPEO, or any of its precursor entities, related entities, or responsible individuals, has failed to pay any applicable federal, state, or local taxes or file any required federal, state, or local tax or information returns in a timely and accurate manner, unless the failure is determined to be due to reasonable cause and not due to willful neglect.

(ii) The CPEO applicant or CPEO, or any of its precursor entities, related entities, or responsible individuals, has been charged or convicted of any criminal offense under the laws of the United States or of a state or political subdivision thereof, or is the subject of an active IRS criminal investigation.

(iii) The CPEO applicant or CPEO, or any of its precursor entities, related entities, or responsible individuals, has been sanctioned, or had a license, registration, or accreditation (including a license, registration, or accreditation relating to its status or

ability to operate as a professional employer organization) denied, suspended, or revoked, by a court of competent jurisdiction, licensing board, assurance or other professional organization, or federal or state agency, court, body, board, or other authority for any misconduct that involves dishonesty, fraud, or breach of trust or that otherwise bears upon the suitability of the CPEO applicant or CPEO to perform its professional functions (including, but not limited to, any civil or criminal penalty described in 42 U.S.C. 503(k)(1)(D) imposed by state law).

(iv) The CPEO applicant or CPEO, or any of its precursor entities, related entities, or responsible individuals, is listed on any sanctions list compiled by the Office of Foreign Assets Control (OFAC) within the Department of Treasury, including, but not limited to the OFAC Consolidated Sanctions List and the OFAC Specially Designated Nationals (SDN) List.

(v) The CPEO applicant or CPEO, or any of its precursor entities, related entities, or responsible individuals, fails to demonstrate a history of financial responsibility, which the IRS may assess by checks on credit history and other similar indicators.

(vi) The CPEO applicant or CPEO and the responsible individuals of the CPEO applicant or CPEO fail to demonstrate adequate collective knowledge or experience with respect to:

(A) Federal or state employment tax reporting, depositing, and withholding requirements;

(B) Handling and accounting of payroll, tax payments, and other funds on behalf of others;

(C) Effective recordkeeping systems;

(D) Retention of qualified personnel and legal advisors as needed; and

(E) General business and risk management.

(vii) The CPEO applicant or CPEO, or any of its responsible individuals, gives false or misleading information (including by intentionally omitting relevant information), or participates in any way in the giving of false or misleading information, to the IRS, knowing, or having reason to know, that the information is false or misleading. For the purpose of this subsection, “information” includes (but is not limited to) facts or other matters contained in testimony, federal tax returns, and financial statements and opinions regarding such statements; applications for certification (and all accompanying documentation); affidavits, declarations, assertions, attestations, statements, and agreements; and periodic verifications that the requirements of this section continue to be met; and any other information that is required to be provided by this section, section 3511(g) and regulations thereunder, or further guidance.

(2) Must be a business entity that is not a disregarded entity. A CPEO must be a business entity described in §301.7701-2(a), except 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 purposes). Accordingly, a CPEO may not be an individual or an entity classified as a trust under §301.7701-4.

(3) Authorization to investigate suitability. A CPEO applicant or CPEO, and each of its responsible individuals, must take such actions as are necessary to authorize the IRS to investigate the accuracy of statements and submissions, including waiving

confidentiality and privilege when necessary, and to conduct comprehensive background checks, including, but not limited to, checks on tax compliance, criminal background, professional experience (including through the contact of third-party references), credit history, and professional sanctions. In addition, a CPEO applicant or CPEO, and any of its responsible individuals, must provide the IRS with such additional information as the IRS may request to facilitate such background investigations. Each responsible individual of a CPEO applicant or CPEO must also submit fingerprints in the time and manner and under the circumstances prescribed by the Commissioner in further guidance.

(d) Business location--(1) State of organization. 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.

(2) Business location in the United States. A CPEO applicant or CPEO must have one or more established, physical business locations in the United States at which regular operations that constitute a trade or business within the United States (within the meaning of section 864(b)) take place and at which a significant portion of its CPEO-related functions are carried on and administrative records are kept.

(3) United States responsible individuals. A majority of the CPEO applicant's or CPEO's responsible individuals must be citizens or residents of the United States.

(4) Use of financial institution. A CPEO applicant or CPEO must use only financial institutions described in section 265(b)(5) to hold its cash and cash equivalents, receive payments from customers, and pay wages and federal employment taxes.

(e) Financial statements--(1) CPEOs. By the last day of the sixth month after the end of each fiscal year, and beginning with the first fiscal year that ends after the CPEO's effective date of certification, a CPEO must cause to be prepared and provided to the IRS a copy of its annual audited financial statements for the fiscal year and an opinion of a certified public accountant (CPA) that such financial statements--

(i) Are presented fairly in accordance with GAAP; and

(ii) Reflect positive working capital or, only if the CPEO satisfies the requirements of paragraph (e)(3) of this section, reflect negative working capital, with such opinion in either case setting forth in detail a calculation of the CPEO's working capital as reflected in the financial statements.

(2) CPEO applicants--(i) In general. A CPEO applicant must cause to be prepared and provided to the IRS, with its application, a copy of its annual audited financial statements and an opinion with respect to such financial statements (as described in paragraph (e)(1) of this section) for the most recently completed fiscal year as of the date it applies for certification. Notwithstanding the preceding sentence, 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 this fiscal year has not yet been completed at the time of application, a CPEO applicant must provide to the IRS, with its application, the financial statements and opinion described in paragraph (e)(1) of this section for the immediately preceding fiscal year, if any, and must subsequently provide to the IRS the financial statements and opinion described in paragraph (e)(1) of this section for the most recently completed fiscal year by the last day of the sixth month after such fiscal year ends. In addition, for any fiscal

year that ends after the CPEO applicant applies for certification and on or before the effective date of certification, if applicable, the CPEO applicant must provide the audited financial statements and opinion described in paragraph (e)(1) of this section by the last day of the sixth month after such fiscal year ends. The obligation to provide the audited financial statements described in the preceding sentence continues to apply even if the CPEO applicant is certified as a CPEO prior to the date the audited financial statements are provided.

(ii) Newly established CPEO applicants. In addition to the requirements in paragraph (e)(2)(i) of this section, a CPEO applicant that was not operating as a provider of employment-related services for all or part of the most recently completed fiscal year as of the date it applies for certification must provide a copy of the audited financial statements of any precursor entity, if one exists, and an opinion with respect to such financial statements (as described in paragraph (e)(1) of this section) for the precursor entity's most recently completed fiscal year as of the date of the application for certification in such time and manner as the Commissioner may prescribe in further guidance, as well as such additional information as the Commissioner may prescribe in further guidance.

(3) Exception to positive working capital requirement. A CPEO applicant or CPEO with annual audited financial statements for a fiscal year that do not reflect positive working capital will not fail to meet the requirements of paragraph (e)(1)(ii) of this section if--

(i) The CPEO applicant or CPEO has negative working capital for no more than two consecutive fiscal quarters of that fiscal year, as demonstrated by the financial

statements (for the final fiscal quarter in the fiscal year) and the statements described in paragraph (f)(1)(ii) of this section (for any other fiscal quarter);

(ii) The CPEO applicant or CPEO, or its CPA, provides, in such time and manner as the Commissioner may prescribe in further guidance, an explanation to the IRS describing the reason for the failure; and

(iii) The IRS determines, in its sole discretion, that the failure does not present a material risk to the IRS's collection of federal employment taxes.

(4) Completed fiscal year. For purposes of this paragraph (e), a fiscal year will be considered completed once the last day of that fiscal year has ended, regardless of whether the CPEO applicant or CPEO was in operation or certified for all 12 months of the fiscal year or the fiscal year consisted of fewer than 12 months.

(f) Quarterly assertions and attestations--(1) CPEOs. By the last day of the second month after the end of each calendar quarter, and beginning with the first calendar quarter, that ends after the CPEO's effective date of certification, a CPEO must provide the following to the IRS:

(i) An assertion, signed by a responsible individual under penalties of perjury, stating that the CPEO has withheld and made deposits of all federal employment taxes (other than taxes imposed by chapter 23 of the Code) as required by subtitle C for such calendar quarter and an examination level attestation from a CPA stating that such assertion is fairly stated in all material respects.

(ii) A statement signed by a responsible individual under penalties of perjury verifying that the CPEO has positive working capital (as determined in accordance with

GAAP) at the end of the most recently completed fiscal quarter, as well as such additional financial information that the Commissioner may specify in further guidance.

(2) Exceptions--(i) Immaterial failures. A CPEO will not fail to meet the requirements of paragraph (f)(1)(i) of this section if the CPA examination level attestation indicates that the CPEO has failed to withhold or make deposits in certain immaterial respects, provided that--

(A) The attestation provides a summary of the immaterial failures that were found;

(B) The attestation states that the failures were immaterial and isolated and do not reflect a meaningful lapse in compliance with federal employment tax withholding and deposit requirements; and

(C) The IRS determines, in its sole discretion, that the isolated and immaterial failures identified by the CPA do not present a material risk to the IRS's collection of federal employment taxes.

(ii) Negative working capital. A CPEO with negative working capital at the end of a fiscal quarter will not fail to meet the requirements of paragraph (f)(1)(ii) of this section if--

(A) The CPEO does not have negative working capital at the end of the two fiscal quarters immediately preceding such fiscal quarter, as demonstrated by the financial statements described in paragraph (e)(1) of this section, if available, or the statements described in paragraph (f)(1)(ii) of this section;

(B) The CPEO provides an explanation to the IRS describing the reason for such negative working capital in such time and manner as the Commissioner may prescribe in further guidance; and

(C) The IRS determines, in its sole discretion, that the negative working capital does not present a material risk to the IRS's collection of federal employment taxes.

(3) CPEO applicants--(i) In general. By the last day of the second month after the end of each calendar quarter, beginning with the most recently completed calendar quarter as of the date of a CPEO applicant's application for certification and ending with the most recently completed calendar quarter as of the effective date of certification (if applicable), a CPEO applicant must provide to the IRS the assertion, examination level attestation, and working capital statement described in paragraph (f)(1) of this section, subject to the exceptions described in paragraph (f)(2) of this section (though substituting "CPEO applicant" for "CPEO").

(ii) Newly established CPEO applicants. A CPEO applicant that was not operating as a provider of employment-related services during the most recently completed calendar quarter as of the date of its application for certification or during any calendar quarter that ends while its application for certification is pending must provide to the IRS the assertion, examination level attestation, and working capital statement described in paragraph (f)(1) of this section with respect to any precursor entity, if applicable, in such time and manner as the Commissioner may prescribe in further guidance, as well as such additional information as the Commissioner may prescribe in further guidance.

(g) Bond--(1) In general. A CPEO must post a bond for the payment of federal employment taxes issued in the form and containing the terms prescribed by the Commissioner in further guidance and in an amount described in paragraph (g)(2) of this section.

(2) Bond amount--(i) In general. The amount of the bond described in paragraph (g)(1) of this section must be, for each period beginning on April 1 of any calendar year and ending on March 31 of the following calendar year (or, in the case of a newly certified CPEO, beginning with the effective date of certification and ending on the subsequent March 31) (the bond period), at least equal to the greater of--

(A) Five percent of the CPEO's liability under section 3511 (or, if applicable, the liability described in paragraph (g)(2)(ii) of this section) during the calendar year preceding the beginning of the bond period, but not more than \$1,000,000; or

(B) \$50,000.

(ii) Amount of bond in first and second year as a CPEO. If a CPEO does not have any liability under section 3511 for all or a portion of a preceding calendar year because the CPEO was not certified as a CPEO for all or a portion of that preceding calendar year, the liability applied for purposes of paragraph (g)(2)(i)(A) of this section for the entirety or portion of the preceding calendar year during which the CPEO was not certified will be the federal employment tax liability of the CPEO, and of any precursor entity of the CPEO described in §301.7705-1T(b)(10)(i)(A), that results from one or more service agreements described in §31.3504-2(b)(2) of this chapter. With respect to the federal employment tax liability of such precursor entity during a preceding calendar year, the liability will only be applied for purposes of paragraph

(g)(2)(i)(A) of this section to the extent it results from service agreements that have been transferred or are intended to be transferred by the precursor entity to the CPEO at the time the bond amount is determined. For purposes of this paragraph (g)(2)(ii), an entity is considered a precursor entity of a CPEO described in §301.7705-1T(b)(10)(i)(A) if it was determined to be its precursor entity under that section at the time it was a CPEO applicant.

(3) Cancellation--(i) Notice. A bond required under this paragraph (g) must provide that it may be cancelled by the surety only after the surety gives written notice of such cancellation to the IRS and the CPEO in such time and manner as the Commissioner may prescribe in further guidance.

(ii) Ongoing liability. A bond required under this paragraph (g) must provide that, if a surety cancels the bond without issuing a superseding bond to the CPEO, the surety will, notwithstanding the cancellation, remain liable for all federal employment tax liability accrued by the CPEO during the period beginning with the effective date of the first bond issued by the surety to the CPEO in any consecutive series of bonds issued by that surety prior to cancellation and ending with the cancellation of the bond (the total bond period), up to the penal amount of the bond at the time of the cancellation. A cancelling surety will remain liable as described in this paragraph (g)(3)(ii) for federal employment tax liability accrued during the total bond period up to the penal amount of the bond for as long as the Commissioner may assess and collect taxes for such period under sections 6501 and 6502.

(4) Strengthening bonds to reflect CPEO adjustment or IRS assessment. In calculating five percent of its liability under section 3511 (or other applicable federal

employment tax liability) for a preceding calendar year for purposes of determining a bond amount, a CPEO must base its calculation on the amount of applicable federal employment taxes that it reported and paid for that preceding calendar year. However, if the CPEO or the IRS subsequently determines during the period for which the bond amount applies that the applicable federal employment tax liability for the preceding calendar year was higher than the amount reported and paid (and makes an adjustment or assessment, respectively, reflecting such determination) and if the bond that the CPEO had posted was less than \$1,000,000, the CPEO must post a strengthening bond that, together with the initially-posted bond, equals a total amount that reflects the adjusted applicable federal employment tax liability up to \$1,000,000. Alternatively, such a CPEO could post a superseding bond in such adjusted amount.

(5) No posting of collateral. A CPEO must meet the bond requirements of this paragraph (g) without posting collateral.

(6) Requirements for surety. Any surety that issues a bond required by this paragraph (g) to a CPEO must be a surety company that holds a certificate of authority from the Secretary as an acceptable surety on federal bonds and meets such other requirements as the Commissioner may prescribe in further guidance.

(h) Controlled group. All CPEO applicants and CPEOs that are members of a controlled group within the meaning of sections 414(b) and (c) will be treated as a single CPEO applicant or CPEO for purposes of paragraphs (e) (other than (e)(1)(ii)), (f) (other than (f)(1)(ii)), and (g) of this section.

(i) Consents to disclose. To receive and maintain certification, a CPEO applicant or CPEO must provide such consents for the IRS to disclose confidential tax information

to its customers, and to other persons as necessary to carry out the purposes of these regulations, that relates to its certification and obligations to report, deposit, and pay federal employment taxes as the Commissioner may require in further guidance.

(j) Periodic verification. A CPEO must periodically verify that it continues to meet the requirements of this section in the time and manner prescribed by the Commissioner in further guidance.

(k) Notification of material changes. A CPEO applicant or CPEO must notify the IRS, in the time and manner prescribed by the Commissioner in further guidance, of any change that materially affects the continuing accuracy of any agreement or information that was previously made or provided to the IRS.

(l) Accrual method of accounting. A CPEO must compute its taxable income using an accrual method of accounting or, if applicable, another method that the Commissioner provides for in further guidance.

(m) Compliance with reporting obligations--(1) In general. A CPEO must agree to make reports to the IRS and to its clients as provided in section 3511(g) and the regulations thereunder, including filing all federal employment tax returns and information returns as required.

(2) Filing on magnetic media. A CPEO must file all returns, schedules, reports, and other forms and documents on magnetic media when required by section 3511(g) and the regulations thereunder or other Treasury regulations.

(n) Suspension and revocation--(1) In general. The IRS may suspend or revoke the certification of any CPEO, in the time and manner and under the circumstances prescribed by the Commissioner in further guidance, as a result of one or more failures

to meet any of the requirements for CPEOs described in this section, section 3511(g) and the regulations thereunder, and any further guidance and will suspend or revoke certification if the IRS determines, in its sole discretion, that such failure(s) present a material risk to the IRS's collection of federal employment taxes. See paragraph (b) of this section for the factors the IRS will consider in determining whether one or more failures to meet any of the requirements described in this section presents a material risk to the IRS's collection of federal employment taxes.

(2) Suspension. Section 3511 will not apply to any contract described in section 7705(e)(2) into which the CPEO enters while its certification is suspended.

(3) Revocation. If an organization's certification as a CPEO is revoked, the organization will not be considered a CPEO for purposes of section 3511 unless and until it again applies to be certified as a CPEO in accordance with paragraph (a) of this section and is again certified by the IRS as meeting the requirements of this section. An organization whose certification as a CPEO has been revoked may not re-apply to be certified as a CPEO until one year has passed since the effective date of its revocation.

(4) Disclosure of suspension and revocation--(i) Notification by the CPEO. An organization whose certification as a CPEO has been suspended or revoked must notify its customers of such suspension or revocation in the time and manner prescribed by the Commissioner in further guidance.

(ii) Disclosure by the IRS. If the IRS suspends or revokes an organization's certification as a CPEO, the IRS will make available to the public the fact of such suspension or revocation in the time and manner described in further guidance. The

IRS may also individually notify the organization's customers of such suspension or revocation.

(o) Effective/applicability date--(1) In general. This section applies on and after July 1, 2016.

(2) Expiration date. The applicability of this section expires on or before May 3, 2019.

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 4. In §602.101, paragraph (b) is amended by adding the following entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where
identified and described

Current OMB
control no.

* * * * *

301.7705-1T.....1545-2266

301.7705-2T.....1545-2266

* * * * *

Kirsten B. Wielobob,

Acting Deputy Commissioner for Services and Enforcement.

Approved: April 28, 2016.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2016-10700 Filed: 5/4/2016 4:15 pm; Publication Date: 5/6/2016]