Tech Firms: When the PEO Arrangement Doesn't Fit, It's Time to Split

By Harrison Newman, Benefits Consultant, Corporate Synergies
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The tech scene is booming. Start-ups are appearing everywhere and New York's "Silicon Alley" is certainly no exception. While Wall Street employment has fallen by more than 25,000 (about 11%) in recent years, citywide tech industries grew by 40,000 workers (57%)—nearly six times faster than New York City overall.[1]

Tech start-ups are typically fast-growing companies launched by everyone from college students to seasoned business executives. The employees skew on the younger side, and they work everywhere and anywhere, often from locations all over the world. Start-ups often hire for talent, regardless of location, and the most successful firms dream of being the next Facebook, Twitter or Google.

Because they're vying for the same talent as major players in the industry, fledgling companies must offer rich employee benefits with perks that will woo A-listers from other jobs. For that reason, many start-up firms contract with a Professional Employer Organization (PEO) to handle their health & welfare benefits and back-office services.

Why the PEO Arrangement Can Be Good for Start-Ups

With a PEO arrangement, a start-up is able to look more like an attractive Fortune 500 company from an employee benefits and compensation perspective. PEOs can offer a shot at better, more cost-effective and competitive health & welfare benefit plans by underwriting smaller groups at rates lower than they would normally qualify for under community rating. They also handle human resources functions like benefits plan management, benefits administration, payroll, taxes, unemployment, workers' compensation, disability, and in some cases, hiring and firing procedures. Because the PEO handles most behind-the-scenes functions, everyone else can focus on their core goal—growing the business. Using a PEO can be the perfect solution for a tech company in its early days.

PEOs provide a co-employment relationship that redefines roles: The start-up is the worksite employer while the PEO is the legal employer.

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But…Rapidly Expanding Firms Will Outgrow a PEO Arrangement

At some point, the start-up will very likely outgrow this co-employment relationship.

Picture this scenario: After just 18 months, a tech start-up using a PEO employs over 100 people, and they're adding more every week. They hope to reach 200 people by year's end. Their new CFO reviews the PEO's administrative costs and wonders what the firm is getting for their money. Aside from health & welfare benefits, payroll and workers' compensation, they're not using many of the services the PEO offers, like training, background checks and reimbursement. Recruitment is done in-house, too.

The payroll system is just okay—it's overpriced and doesn't offer any real bells and whistles. The PEO charges upward of $100,000 in administrative fees.

The Transition: Not Like Flipping a Switch

As a general rule, a company that expands to more than 100 full-time equivalent employees should begin to consider moving away from a PEO arrangement because there can be significant savings in the open employee benefits market. Ditto for workers' compensation. A Corporate Synergies' client in Brooklyn that grew from 20-120 employees in under two years saved 29%, which equated to $386,000 annually.

Tech firms can have a better chance of getting lower rates on health plans because of their favorable demographic (young and healthy with few medical claims) and they'll have more plan options than the fixed choices offered by the PEO. They may also have a shot at lower rates for workers' compensation and other liability insurance, but more than anything, leaving a PEO arrangement allows them the flexibility to build a truly customized employee benefits package, with worksite products, health & wellness programs, and the potential to self-insure.

Because a PEO controls and manages so many critical business elements like health insurance, compliance, payroll, retirement funds and COBRA, the idea of leaving might seem daunting. Breaking away requires a complete exit strategy to mitigate these issues and disruptions. Timing is everything; the time you leave a PEO arrangement could have a substantial impact from a tax, cost, benefits and compliance standpoint. Since this is not an overnight decision, most growing companies lean heavily on experienced benefits consultants and third-party solutions (such as payroll services) to guide them in the right direction.

With the right model, and right execution, the growing pains from leaving a Professional Employer Organization aren't so painful, and will help carry you to the next level one step closer to that big IPO.

[1]Libertystreeteconomics.newyorkfed.org, "Will Silicon Alley be the Next Silicon Valley?"

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