Tax Issues to Consider When Sharing Employees

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Introduction

We all know the phrase, "sharing is caring," but not many of us follow up by asking, "but what are the tax implications?" Any community action agency (CAA) that has successfully shared employees with another entity knows the benefits that can result. CAAs often operate with limited resources, and sharing employee costs with other organizations can be an effective way to achieve economies of scale among like-minded entities. Highly qualified candidates often come in short supply, and certainly do not come cheap, so a CAA might need to join with another employer to offer the competitive salary and benefits necessary to attract that candidate. CAAs might also have a related 501(c)(4) entity or for-profit social enterprise, and sharing certain employees may present opportunities for training and growth, while also achieving cost savings.

This article focuses on the tax considerations for CAAs entering into a shared employee relationship. It presents three commonly-seen examples of sharing employees within the Community Action network: (1) a 501(c)(3) nonprofit state association sharing employees with another tax-exempt organization, such as a 501(c)(4) organization; (2) a nonprofit CAA sharing employees with a for-profit subsidiary that is formed to operate the CAA's social enterprise; and (3) a nonprofit CAA sharing employees with another nonprofit CAA or a nonprofit community partner organization. The article discusses the implications of each of these arrangements on a private, nonprofit CAA's tax-exempt status,[1] as well as issues related to withholding and paying payroll and employment taxes for shared employees. While it discusses major tax issues present in these scenarios, it is not exhaustive, and any CAA interested in entering into a shared employee arrangement should consult with local counsel.

Though not addressed in this article, CAAs interested in sharing employees will need to consider other legal issues. Determining and assigning key employer responsibilities as part of a shared employment relationship is critical. This involves properly classifying shared workers as employees or independent contractors. Factors such as control, supervision, and payment of workers will need to be analyzed. Depending on how they are classified, different obligations around payments, filings, and taxes for those workers will exist. Further, a joint employment relationship could exist where two employers share control over an employee performing the same work for each, and both are responsible for the payment of minimum wage and overtime under the applicable wage and hour laws. These are just some of the issues that a CAA sharing employees with another entity must address prior to entering into the relationship, to help it avoid potential pitfalls and penalties down the road.

A note on "non-charitable organizations". This article makes several references to "non-charitable organizations" that a nonprofit CAA may share employees with. For the purposes of this article, a **"non-charitable organization"** means one which has not received a 501(c)(3) tax-exempt, charitable designation from the IRS. Private, nonprofit CAAs and state/regional associations are generally classified as **"charitable organizations"** because of their 501(c)(3) tax exempt status. Non-charitable organizations, on the other hand, include other types of tax-exempt entities, including 501(c)(4) social welfare organizations and 501(c)(6) business leagues/associations, as well as for-profit entities such as C corporations and privately owned limited liability corporations (LLCs).

A note on "related organizations". This article also references "related organizations". While the IRS and often state nonprofit corporation laws contain a technical definition of when two or more organizations are "related" to one another, for purposes of this article, the term **"related organizations"** refers to organizations that are under some form of common control. Examples include two organizations having a majority of overlapping board members, one organization having the ability to designate or elect a majority of the board members of another organization, or one organization holding a majority of the outstanding stock of the other organization.

Example 1: A nonprofit state association (501(c)(3)) wants to share employees with a 501(c)(4) organization that the state association has established to lobby on behalf of the CAAs in the state, and all of the board members of the 501(c)(4) organization also sit on the 501(c)(3) state association's board.

Protect Your 501(c)(3) Tax-Exempt Charity Status

Whenever a charitable organization is sharing resources with a non-charitable organization, including sharing employees, it is critical to ensure the charitable organization receives fair compensation for any services provided to the non-charitable organization. This is necessary to protect the charitable organization's status as a charity, which confers benefits that non-charitable organizations (even if they are tax-exempt) don't enjoy. For example, a charitable organization can solicit individual and corporate contributions that are tax-deductible to the donor. Further, many foundations and government agencies limit their grants to charitable organizations.

In this example, the state association is the 501(c)(3) tax-exempt charitable organization and cannot spend funds on activities that do not further its charitable purpose, including political activity and substantial lobbying.[2] The state association must be careful that in sharing resources with a non-charitable organization, it is not indirectly engaging in political activities and unlimited lobbying by financially subsidizing the 501(c)(4) organization's operations. This means that the state association must be able to show that it is receiving fair payment for the cost it incurs to share employees with the 501(c)(4) organization, and is not inadvertently paying the portion of a shared employee's salary that should have been charged to the non-charitable organization. Failing to do so could jeopardize the state association's charitable status.

Keep Accurate and Contemporaneous Records

To protect against these risks, employers must ensure that shared employee records are accurate and contemporaneous. Related organizations like those in Example 1 that share employees can run into trouble because they are often well acquainted with one another, and in some cases the shared employees work in the same location. This can make it difficult to set parameters that establish and record when a shared employee is working for which employer, and who should be paying the employee for what time worked.

Employers should give shared employees a clear and defined schedule, and clarify expectations around when the employees are to be working for which employer. Schedules with a clean split are preferable. In Example 1, a shared employee could be assigned to work for the state association on Monday, Thursday, and Friday, and for the 501(c)(4) on Tuesday and Wednesday each week. In addition, shared employees should regularly track the time that they work for each employer and submit timesheets on a weekly basis that reflect those hours worked. That way, each organization understands exactly how much time the shared employee worked for that organization, and pays for the actual amount of time worked. In addition, employees working for two (or more) organizations must be mindful to do the work for each organization using that organization's resources (email, phone, etc.). The costs of shared equipment (such as a laptop) and overhead should be allocated in accordance with the proportion of time that the employee works for each organization.

What if an unforeseen development forces a change in schedule? Say a shared employee must work an extra day one week for the state association. Does the day need to be made up or does the state association adjust its allocation of the employee's pay for that week? In this situation, it is critical that the charitable organization (the state association) pay no more than the actual amount of time that the shared employee worked for the charitable organization. Conversely, it is less important for the shared employee to make up the time for the 501(c)(4) because it does not jeopardize the 501(c)(4)'s tax-exempt status to provide uncompensated value to a charitable organization with an aligned mission. As a result, the 501(c)(4) organization could simply decide to make a donation, in the form of one day's salary covered, to the charitable organization, without jeopardizing the 501(c)(4) organization's tax exemption. If the situation were reversed, however, and the employee unexpectedly worked at a time allocated to the state association on behalf of the 501(c)(4), that must be noted and paid for by the 501(c)(4). Again, the underlying principle is that the charitable organization must be fairly compensated and cannot be seen as making a "donation" to a non-charitable entity, as this could jeopardize the charitable organization's exempt status.

Who Pays the Shared Employees, and Who Pays the Taxes?

Determining which organization pays the shared employees' salaries, and which organization is responsible for the administration and payment of employment taxes, is a major consideration in shared employee situations. Indeed, Section 3401(d) of the Internal Revenue Code (IRC) states that if a party is "in control of the payment of wages," it may be considered the employer for purposes of income tax withholding.[3] The Section 3401(d) employer is solely liable for reporting and paying the employment taxes in connection with the wages that it pays, even if it is not the "common law" employer.[4] Thus, it is important to determine, at the outset of the arrangement, which employer controls payment of wages of shared employees.

As is always the case with multiple employers who have employees in common, each employer may always simply hire the shared employee for the time the employee works for that employer, and pay the shared employee separately, according to their own respective employment policies and practices. But what options might be available if one of the organizations is better positioned to handle the administration of payroll and employment taxes for the shared employee? After all, if both organizations have to be responsible for hiring, paying, and administering payroll for each of their shared employees, haven't they lost some of the economies of scale and efficiencies achieved by sharing? Thankfully, under IRS rules, there are several payroll/tax filing options that allow organizations with shared employees to streamline payroll administration. A more detailed discussion of these options is below. First, however, let's focus on one option that is only available to certain related entities: the **common paymaster**.

Consider the Common Paymaster

Since the organizations in Example 1 are related and share the services of one or more employees, they may qualify for an arrangement called the **common paymaster**. This arrangement allows one of the related entities, referred to as the "common paymaster," to pay the employee(s); prepare, sign, and file the employment tax returns; and deposit employment taxes for all of the work a shared employee performs for all related organizations. To qualify for this arrangement, the organizations sharing the employees must meet **one** of the following tests, which are looking for a degree of common control between the organizations:

1. Either 50% or more of the members of one organization's board of directors must be members of the other entity's board of directors **OR** the holders of 50% or more of the voting power to select such members are concurrently the holders of more than 50% of that power with respect to the other corporation;
2. At least 50% of the officers of one organization are concurrently officers of the other entity;
3. At least 30% of the employees of one organization are concurrently employed by the other entity; or
4. The organizations are members of a "controlled group of corporations" (as defined in IRC Section 1563 or Treas. Reg. 31.3121(s)-1(b)(1)(i), which is based on stock ownership).[5]

In Example 1, since the state association and 501(c)(4) organization have overlapping board members such that 100% of the 501(c)(4)'s board members overlap with the board of the state association, they satisfy the first common paymaster test described above, and may use this option. This means that either the state association or the 501(c)(4) organization may be designated as the "common paymaster" and as such, take on the responsibility of paying and administering payroll taxes for all the work performed by the shared employee, for both organizations.

As noted above, the common paymaster option will not apply in all scenarios involving related entities sharing employees. If the related entities do not meet one of the four tests, another option will need to be used (see below for discussion of other payroll/employment tax payment options). If, however, the common paymaster rule applies, it can simplify the administrative burden of sharing employees and create a more efficient payroll process for those employees. Note too that the common paymaster option is only applicable to the employees that the related organizations share.

Nuts and Bolts of the Common Paymaster Process

After determining eligibility for the common paymaster option, the entities must decide who the common paymaster will be. Factors that may influence the decision include which organization has the capacity, effectiveness, and availability of resources to do so. For example, if one organization is larger and has a more established payroll process than the other organization, it may make sense to designate the larger organization as the common paymaster. Once the common paymaster is chosen, that entity may use its own EIN on the tax return prepared for the shared employees. Further, the common paymaster is not required to file a Schedule R for Form 940 or allocate wages among the related employers.

It is important to note that, in this common paymaster arrangement, the total compensation paid by all the related organizations for a shared employee establishes the employee's wage base for purposes of calculating Federal Insurance Contribution Act (FICA) payroll taxes. As a result, the common paymaster option is both administratively and tax efficient.

Once the common paymaster handles the payroll and tax administration for the shared employee, it would bill the other employer for the payroll costs allocated to work performed for the other employer. This can be accomplished through a payment, invoice, or reimbursement process between the employers.

Example 2: A nonprofit CAA (501(c)(3) charitable organization) wants to share employees with a for-profit corporation, which is a subsidiary of the CAA and set up to operate the CAA's social enterprises. All five of the for-profit subsidiary's employees will be shared with the CAA.

Properly Classify Employees and Keep Accurate and Contemporaneous Records

As with Example 1, the issues around classifying employees and keeping accurate and contemporaneous records are basically the same and remain essential in this example. Remember, any discrepancies or misallocated funds may result in risks to the CAA's tax-exempt status.

And Expect Greater Scrutiny!

And expect inquiries. A charity sharing resources with a related for-profit organization will often invite greater scrutiny over its activities. Think about it—a charitable CAA has a for-profit subsidiary. The CAA generates funds to support its charitable programs through that entity, but a nonprofit CAA should not be in business to conduct a commercial or non-exempt activity. Rather, it exists for a charitable purpose. While separate corporate structures delineate important boundaries between the CAA's charitable activities and the subsidiary's for-profit endeavors, sharing employees risks blurring those lines and introducing confusion about the relationship. Regulators might be eager to clarify that relationship and ensure that both entities are operating as they are supposed to, for their proper purposes, and pursuant to applicable rules and regulations.

Here, the CAA should be aware of the optics of having employees of the nonprofit organization also serve a for-profit business function at the non-charitable organization. One way to mitigate the potential concerns is to structure the arrangement as a sweetheart deal for the CAA. For example, the five employees could be employed by the for-profit entity and leased to the CAA at below-market rates (for example, the for-profit subsidiary charges the CAA an hourly rate for the shared employees' time that is less than the hourly rate the for-profit entity pays the shared employee). This arrangement often makes sense because leasing employees is not a tax-exempt activity, so having the for-profit entity employ and lease the employees will raise fewer questions. A nonprofit CAA that leases employees to a for-profit entity would need to ensure that the activity does not rise to a substantial level.

Determine Who Pays the Employees and Who Pays the Taxes

The good news for the CAA in this example is that its relationship with its subsidiary and the fact that all the for-profit's employees will be shared means that it meets the common paymaster criteria and can take advantage of that arrangement, if it so chooses. If the employees are leased by the for-profit entity to the CAA, as discussed above, then the for-profit entity could serve as the common paymaster and administer payroll, taxes, and filings. Of course, the organizations still have the option to hire the shared employees and pay them separately, according to their own respective employment policies and practices. These entities may also explore another of the payroll and employment tax options listed below.

Example 3: Two unrelated nonprofit CAAs, both 501(c)(3) organizations, want to share a Chief Financial Officer (CFO), whose time will be split evenly between them.

Classify the Executive Staff and Officers as Employees

To start, these CAAs will want to ensure that they each classify the CFO as an employee. IRS rules require officers of an organization to be treated as employees. In this example, the CFO will serve as an officer of both CAAs, so each must treat the CFO as an employee.

Agree on the Terms in Writing

The CAAs should enter into a shared services or written agreement defining the arrangement to share the CFO's employment. This agreement should detail how much time the CFO should be devoting to each employer, and the CFO's schedule for doing so. It will also typically include any shared supervisory roles, and information on payment and whether the employee is eligible for either employer's benefits. This agreement helps the organizations establish the boundaries that assist with employee administration and oversight.

Determine Who Pays the Employee and Who Pays the Taxes

As these two CAAs are unrelated, they cannot utilize the common paymaster option. The two organizations can always separately hire the same CFO on a part-time basis and pay this individual according to their respective practices. For the reasons stated above, it is not recommended that one nonprofit CAA lease employees to another since employee leasing is generally not considered by the IRS to be a related activity for a 501(c)(3) organization. However, since this situation involves only one shared employee and there is no risk of private benefit if one 501(c)(3) organization leases an employee to another, it might not rise to the level of an activity substantially unrelated to the lessor organization's charitable purpose, and the CAAs may determine that this is the best option moving forward. This may be the case if resources or capacity of the employing CAA far exceed those of the other.

If, however, the CAAs want to designate one CAA to perform all payroll and employment tax filing functions, the agencies have several permissible options under IRS rules:

- Payroll Service Provider
  Under the payroll service provider option, one organization is deemed to be an agent of the other organization in connection with preparing and filing payroll tax returns for the shared employee(s). In this arrangement, one organization prepares and files tax returns (Form 941, W2s, Form 990, employment tax returns) and makes deposits of employment taxes on the other organization's behalf. The organization serving as agent for the other does not use its own EIN on the payroll tax returns prepared for the other organization, and does not sign them. It is also not liable for failure to remit the payroll taxes that are due. A CAA might choose this option if it is serving as agent for the other but wants to limit its liability for the other organization's payroll taxes. Or the CAA may not want the other organization (serving as agent) to sign payroll tax returns on the CAA's behalf.

- Reporting Agent
  A reporting agent provides services authorized under a reporting agent authorization. This authorization is provided by the other organization that employs the shared employee(s) by filing IRS Form 8655: Reporting Agent Authorization. The employer acting as the reporting

agent prepares, signs, and files tax returns (Form 941, W-2s, and employment tax returns) and makes deposits of employment taxes on the other employer's behalf. The reporting agent does not use its own EIN on the other employer's payroll tax returns, and is not liable for failure to remit taxes that are due. The main difference between this Reporting Agent arrangement and the Payroll Service Provider arrangement is that a reporting agent does sign tax returns on behalf of the other organization. This may be appropriate if the CAA is comfortable with the other organization signing the payroll tax returns on the CAA's behalf. In some cases this may be more administratively efficient than the payroll service provider option.

- Section 3504 Agent
  The Section 3504 agent is authorized under IRS Form 2678 to provide more comprehensive third-party services. The Section 3504 agent may also be designated via a shared services agreement between the parties that designates the Section 3504 agent to pay wages, prepare and file returns, and pay employment taxes under the agent's name and EIN with respect to the employer's employee(s). The Section 3504 agent prepares, signs, and files tax returns (Form 941, W-2s, employment tax returns) and makes deposits of employment taxes on the other organization's behalf. The Section 3504 agent may use its own EIN on the tax returns and is jointly liable for failure to remit the taxes that are due. The Section 3504 agent also files an aggregate return under its own name and EIN (Schedule R attached to the agent's Form 941 to allocate wages to the other organization(s) for whom it serves as agent). This option may be most appropriate for organizations that have a close relationship within which there is a high level of shared trust. The Section 3504 agent must have the internal administrative sophistication to prepare the payroll tax returns in this manner.

These examples assume that both organizations employ the shared employees. However, a payroll service provider, reporting agent, and Section 3504 agent can also be an independent contractor to a CAA and provide these services without sharing employees with the CAA.

Conclusion

Sharing is caring, and the tax implications of sharing employees are not so onerous as to render the process untenable. If understood, clarified, and planned for, CAAs can successfully navigate the major tax issues present in any number of different shared employee situations, so that they stand to reap the benefits of these relationships and the work product that results.

Endnotes

[1] Private, nonprofit CAAs are typically tax-exempt under section 501(c)(3) of the Internal Revenue Code. This classification requires, among other things, that they be organized and operated for a charitable purpose. See 26 U.S.C. § 501(c)(3).

[2] A 501(c)(3) organization can engage in an insubstantial amount of lobbying but must do so using non-federal, unrestricted funds. Whether that lobbying is considered "substantial" will be determined by examining the particular "facts and circumstances" of it (known as the "substantial part" test), or by an "expenditure test" election made by the organization under Internal Revenue Code section 501(h).

[3] See 26 U.S.C. § 3401(d).

[4] In general, the "common law" employer is the entity that has control over the employee's work and how it is done.

[5] Because this scenario defines common control based on one entity's ownership of stock in another entity, it typically will not apply to nonprofit CAAs and state associations, as nonprofit organizations do not have outstanding shares of stock. However, this scenario could apply if a nonprofit CAA or state association has a for-profit subsidiary and the nonprofit organization owns all or a majority of the outstanding shares of the for-profit subsidiary. This is most likely to happen if the nonprofit CAA or state association has a social enterprise that is operated out of a separate legal entity (which is most likely a for-profit entity with outstanding shares of stock).

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