


Staffing Companies and their Clients Face Significant Sales Tax Risk

Staffing companies offer their clients the opportunity to increase productivity and flexibility, while at the same time helping clients decrease costs. However, in some states, these benefits come at a cost in the form of a sales tax assessed on the provision of employment staffing and placement services. Ohio, New York, Texas and Pennsylvania are just a few such states. While these states typically provide statutory exemptions for certain transactions, state tax departments strictly construe those exemptions. Like other states, under Ohio law, the tax is



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imposed on the client, but the staffing company is charged with collecting it as trustee for the state.¹ This allows the state to go after either party for the tax, though states often concentrate their efforts on the staffing companies since they offer a bigger prize. As discussed in more detail below, in recent sales tax audits that we have handled, a lack of attention to detail has resulted in six figure assessments against staffing companies and clients.



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Ohio Sales Tax Basics

Under Ohio law, a transaction pursuant to which an employment service is provided is a taxable sale.² "Employment service" is defined as the provision of personnel to a client, on a temporary or long-term basis, to work under the supervision of another, when the provider supplies wages, compensation and other benefits to the personnel. Like other states, Ohio establishes several exemptions from this general rule, including the one that is the focus of this alert - the permanent leased employee exemption. The statute exempts transactions whereby personnel are provided "to a purchaser pursuant to a contract of at least one year between the service provider and the purchaser

that specifies that each employee covered under the contract is assigned to the purchaser on a permanent basis."³ In order to qualify for the exemption, the relationship between the staffing company and the client must satisfy two requirements – a contract requirement and an actual practice requirement.

The staffing services must be provided pursuant to a contract that has an initial term of at least one year and provides that all assigned personnel are provided on a permanent basis. There is case law in Ohio indicating that this requirement can be satisfied with an oral contract. However, it is difficult to prove the existence and duration of an oral contract so the contract should always be in

writing and should expressly state that the initial term is one year and all personnel supplied pursuant to the contract are provided on a permanent basis.

The second requirement for the exemption is that the personnel must in fact be provided on a permanent basis. In *H.R. Options, Inc. v. Zaino*, the Ohio Supreme Court defined “permanent basis” to mean that employees are assigned for an indefinite period, i.e., the employee’s contract does not specify an ending date and the employee is not being provided either as a substitute for a current employee who is on leave or to meet seasonal or short term work load conditions. The Court also held that both the terms of the contract and the facts and circumstances of the employee’s assignment are factors that must be reviewed to determine whether the employee is being assigned on a permanent basis.

What Does This Mean To You?

So what does this mean to staffing companies and their clients? Any of the following factors create a significant risk of a sales tax assessment if audited:

- There is no written contract or the contract is not for an initial term of one year.
- The written contract does not provide that all personnel are provided on a permanent basis.
- Any personnel provided pursuant to the contract are used to meet short term work demands, seasonal needs, or to fill in for employees who are on leave.
- Significant fluctuations in the number of personnel provided over a period of time.
- The staffing arrangement is used as a short term screening process for individuals who will be hired directly by the client.

- The staffing agreement provides for a specific end date.
- The staffing company has contracts with the individuals being provided indicating they are being hired for a fixed period of time, rather than indefinitely.

The Ohio Department of Taxation takes the position in Information Release ST 1993-08 that if at least one employee covered under the employment service contract is not assigned on a permanent basis, then the entire contract may be considered taxable. It is doubtful that position is supported by the statute; however, it highlights the importance of being sure that all personnel provided under a contract that is intended to qualify for the permanent leased employee exemption are provided on a permanent, indefinite basis.

Although this exemption has been around since the early 1990s, we continue to see very substantial assessments against staffing companies and their clients for failure to satisfy the requirements of the permanent leased employee exemption. We have seen staffing contracts that state that all personnel are being provided on a permanent basis but elsewhere in the contract it states that the personnel are being provided on a temporary basis. Frequently, we see situations where the contract satisfies the exemption requirement, but a review of the facts and circumstances of the actual arrangement indicates significant variations in the number of individuals provided over a period of time. For example, if the staffing company routinely provides approximately 30 individuals per week but at some point during the year the number increases to 40 or 50 individuals for a period of weeks and then returns to approximately 30 individuals, it is very likely that an auditor will assume such fluctuations indicate that personnel are

being provided to fill seasonal or short term needs and do not qualify for the permanent leased employee exemption. As noted above, the Department of Taxation’s position is that supplying any temporary personnel will taint the entire contract. In two recent audits, the State assessed 100% of the staffing company’s charges even through it was clear that many of the individuals were assigned on an indefinite basis. The amount of the assessment in such cases will likely be reduced on appeal, but an appeal can be expensive both in terms of legal fees and internal resources. Further, a sales tax appeal in Ohio currently takes two to five years to resolve. During that period, the sales tax exposure continues to grow.

An Ohio sales tax audit usually covers a period of three years, although it can go back further if the taxpayer being audited has not filed sales or use tax returns. If you are a staffing company client that incurs average weekly charges of \$10,000, over a period of three years the sales tax assessment could easily be \$100,000 plus penalties and interest. If you are a staffing company that has ten customers doing that volume of business, failure to strictly comply with the requirements of the exemption could subject you to an assessment of over \$1 million, plus penalties and interest.

Recommendation

If the intent is to qualify for the permanent leased employee exemption, we recommend that both parties to a staffing company contract carefully review the contract to be sure it satisfies the statutory requirements and does not include any extraneous or confusing language. Staffing companies and their clients should also review the actual flow of employees over the last few years to identify any fluctuations that could be an indication of temporary, seasonal or short term staffing. It is quite common for a

staffing company to provide personnel on a permanent, indefinite basis and on a short term or temporary basis to the same client. In that case, there should be two contracts between the parties – one that satisfies the permanent leased employee exemption and another pursuant to which the temporary or short term personnel are provided. Temporary personnel should be provided only under the second agreement and sales tax should be added to the invoice for the services of those individuals. Clients should not rely on assurances from the staffing company that the arrangement is exempt. The tax is imposed on the client and it is the client's obligation to be sure that exempt arrangements are properly structured and sales tax is paid on temporary personnel.

If you have any questions or concerns regarding your existing staffing contracts or whether the personnel provided under those contracts qualify for the permanent leased employee exemption, please contact us.

For additional information, contact Mike McGowan at mmcgowan@slk-law.com or 419.321.1227.

Footnotes

¹ O.R.C. 5739.03.

² O.R.C. 5739.01(B)(3)(k).

³ O.R.C. 5739.01(JJ)(3).