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The Affordable Care Act—Countdown to Compliance for Employers, Week 17: Cherry Bomb in the Gold Fish Pond, or Third-Party Staffing Arrangements and "Offers of Coverage by Unrelated Employers"

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With two seemingly simple and straightforward definitions in the **final regulations** implementing the Affordable Care Act's pay-or-play rules—i.e., definitions of "employer" and "employee"— the Treasury Department and IRS have raised a host of concerns for third party staffing arrangements. (The IRS has provided a useful summary of the final regulations in a set of **Questions and Answers**.) Both definitions adopt the "common law" standard. In so doing, there is no evidence that the regulators intended to change prior law. But unwittingly or otherwise, the preamble to the final regulations provides ample evidence that the industry's view of these terms is at odds with that of the regulators.

For decades, the mainstream staffing industry, with ample legal precedent, has considered the workers that staffing firms place with their clients as common law employees of the staffing firm, and not the client. This is in marked contrast to Professional Employer Organizations (or "PEOs") that, at least since 2002, have generally, though not universally, considered their external workers to be the common law employees of the client. Treasury and IRS guidance in the matter is generally sparse, as is judicial authority. This is understandable since staffing firms and PEOs generally treat their external workers as employees and not independent contractors. The question was not, "is this worker an employee or an independent contractor," it was, instead, "whether the worker is the common law employee of the staffing firm or the client organization." Thus, *someone* is issuing a Form W-2 to the workers, so misclassification generally did no harm to the U.S. Treasury. Code § 4980H complicates this calculus.

Both the preamble to the final regulations and the regulations themselves recognize that three-party employment arrangements pose unique issues. In a handful of instances, the regulations endeavor to provide accommodations and special rules. For example, when determining a newly hired employee's status as "variable hour," the final regulations provide additional factors to be considered in the case of employees "hired by an employer for temporary placement at an unrelated entity"— factors specifically designed to apply to temporary staffing firms who are common law employers.

The final regulations also recognize that in some third-party staffing arrangements, the staffing firm, and not the client organization, will make the offer of group health plan coverage that is intended to satisfy the pay-or-play rules. The regulations permit an offer of coverage by an unrelated employer in cases where the employee to whom coverage is offered by the staffing firm is the common law employee of the client. This rule could be used either intentionally, e.g., by a PEO that offers group health plan coverage, or prophylactically, e.g., contractually, as an audit safe harbor. In either case, the staffing firm or PEO must charge an additional fee with respect to employees that actually accept coverage. The purpose of the fee is to treat the coverage as being paid for in whole or in part by the client organization.

To understand what is at stake, consider the following example:

Employer X has 300 full-time employees, 100 of whom are retained through Staffing Firm Y. Employer X makes an offer of minimum essential coverage to its remaining 200 full-time employees under an eligible employer sponsored plan maintained by Employer X. Under the terms of the staffing agreement, Staffing Firm Y must make an offer of minimum essential coverage to any full-time employee who it places with Employer X under an eligible employer sponsored plan maintained by Staffing Firm Y. If the employees placed through Staffing Firm Y are the common law employees of Employer X and not of Staffing Firm Y, then, in the absence of the rule governing offers of coverage on behalf of another entity, Employer X would owe an assessable payment under Code §4980H(a), since it would have made an offer of coverage to only 66% of its full-time employees. But if the conditions of the special rule governing offers of coverage on behalf of another entity are satisfied, then Employer X would be deemed to have made an offer of coverage to 100% of its full-time employees, thereby escaping exposure under Code §4980H(a).

As a consequence of the rule recognizing offers of coverage by unrelated employers, third-party employment arrangements have a way to navigate the Act's employer shared responsibility rules. That's the good news. The bad news is that there are other laws—Federal and state—that the final regulations do not address. These include the following:

- MEWA status of the staffing firm's group health plan

If employees placed with a client organization are the common law employees of the client organization but are covered under the staffing firm's group health plan, then that plan is, and is regulated as, a multiple employer welfare arrangement. If the plan is fully insured, then it may violate the terms of the agreement with the carrier that is under the impression that it is insuring a single-employer plan. In addition, if the client organization is a small group, the plan may run afoul of the state's small group requirements. The arrangement must also file annually a Form M-1 with the Department of Labor. And if the plan is self-funded, then the arrangement would likely constitute an unlicensed insurance company for state law purposes, or, in the alternative, fail to satisfy any separate state law governing self-funded MEWAs.

- Loss of tax deduction/exclusion under Code §105, §106, and §125

Amounts paid or reimbursed under a group health plan to or on behalf of employees and their dependents are deductible from an employee's gross income under Code §105, and pursuant to Code §106 an employee's gross income does not include the value of group health plan coverage. Similarly, group health plan contributions made by participants are excluded from gross income if made under a properly structured cafeteria plan that satisfies the requirements of Code §125. The term "cafeteria plan" means a written plan under which "all participants are employees." Where a group health plan covers individuals who are not common law employees of the staffing firm, then the Code §105 deduction and the §106 exclusion are unavailable. While the final Code §4980H regulations do not address these issues explicitly, the additional fee requirement appears to be intended to treat the plan as offered or paid for by the client, thereby preserving these deductions and exclusions.

- Impact on other benefit plans and programs

A determination that the employees being placed with a client organization are employees of the client affects other benefit programs. For example, if a staffing firm offers a 401(k) plan that covers the employees placed with a client organization, the plan would have to be structured as a multiple employer plan. This would require, among other things, separate testing of the employees assigned to the client.

For an in-depth discussion of these and other issues arising under the rules governing offers of coverage to unrelated employers, including the historical treatment of staffing firms as common law employers, please see our article entitled ***The Final Code §4980H Regulations; Common Law Employees; and Offers of Coverage by Unrelated Employers***, to be published in the September 8, 2014 issue of the Bloomberg/BNA Tax Management Memorandum.

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