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The Common Law Employer Test and the Affordable Care Act — Will Businesses Be Responsible for Temporary Employees Assigned by Staffing Firms?

By Alden J. Bianchi and Edward A. Lenz[1]

The Patient Protection and Affordable Care Act (''ACA'')[2] added to the Internal Revenue Code (''Code'') new Code §4980H governing ''shared responsibility for employers regarding health coverage.'' Under these rules, each ''applicable large employer''[3] must make an offer of group health plan coverage to its full-time employees or face the prospect of a penalty. In a two-party employment arrangement, involving an employer and an employee, identifying which individuals are ''employees'' is relatively simple and straightforward. The determination is more complicated, however, where the employer instead retains the services of temporary and contract workers through a third-party staffing firm. For purposes of applying Code §4980H, are these workers employees of the staffing firm, the client organization to which they are assigned, or both? In proposed regulations released December 28, 2012, and published in the Federal Register on January 2, 2013 (the ''proposed regulations''),[4] the Treasury Department and the Internal Revenue Service suggest an answer: a worker's status as an employee for the purpose of complying with Code §4980H is determined under the ''common law employee'' standard.

Since the foundation of the modern staffing industry after World War II, a central industry operating premise has been that staffing firms are employers of the workers assigned to clients with respect to compliance with employment, tax and employee benefits laws — a premise that is generally, if not always perfectly, consistent with applicable tax laws and doctrines. Regulators rarely challenged this operating premise. They instead focused on abuses involving the misclassification of workers as independent contractors to avoid exposure for employment taxes and for wage withholding at the source. If an entity classified a worker as an employee, that was usually the end of the inquiry. It is not yet clear whether the ACA's employer shared responsibility requirements will change this calculus. We believe that there are compelling legal and policy reasons that it should not.

In this paper we seek to establish that, based on longstanding practice as well as past and current legal precedent, staffing firms, in the vast majority of cases, either are or *should be* treated as the common law employer of the temporary and contract workers assigned to client organizations for purposes of Code §4980H. We also suggest an alternative regulatory approach under which the Code §4980H offer of coverage made by a staffing firm to full-time workers placed with a client organization would be treated as made by the client organization under traditional agency law principles.

Section I below provides an overview of who is a ''common law'' employee.[5] Section II explains the difference between the application of the common law employee rules to temporary and contract staffing firms as opposed to ''Professional Employer Organizations'' (or PEOs). Section II also explains and provides historical context for understanding the term ''leased employee.'' In Section III, we explore the im-

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[2] P.L. 111-148, 124 Stat. 119 (2010), as amended by (i) the Health Care and Education Reconciliation Act of 2010 (HCERA), P.L. 111-152, 124 Stat. 1028 (2010), (ii) the TRICARE Affirmation Act, P.L. 111-159, 124 Stat. 1123 (2010), (iii) the Medicare and Medicaid Extenders Act of 2010, P.L. 111-309, 124 Stat. 3285 (2010), (iv) the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, P.L. 112-9, 125 Stat. 36 (2011), (v) the Department of Defense and Full-Year Continuing Appropriations Act, 2011, P.L. 112-10, 125 Stat. 38 (2011), and (vi) the 3% Withholding Repeal and Job Creation Act, P.L. 112-56, 125 Stat. 711 (2011) (collectively, the ''ACA'' or ''Act'').

[3] Discussed in Section III(a), below.

[4] 78 Fed. Reg. 218 (1/2/13).

[5] See generally Bianchi, 399 T.M., *Employee Benefits for the Contingent Workforce* (explaining in detail the origins, development, and current status of the common law employee doctrine).

pact of Code §4980H and the proposed regulations on staffing and PEO arrangements. Section IV offers a regulatory solution for protecting client organizations even if the client organization, and not the staffing firm, is determined to be the common law employer, and Section V summarizes our conclusions.

I. COMMON LAW EMPLOYEES

Both the Code (for Federal tax purposes) and the Employee Retirement Income Security Act of 1974[6] (''ERISA'') (for employee benefits purposes) determine employee status by applying the ''common law agency'' or, simply, the ''common law'' test.

(a) The Code

For purposes of the Code a common law employee ''includes every individual performing services if the relationship between him and the person for whom he performs such services is the legal relationship of employer and employee.''[7] The Treasury Department, in regulations issued under the employment tax rules, provides the following concise statement of common law employee status:

> Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. *In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so.* The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. . . .[8] (Emphasis added).

This definition is applied in the rules governing employment taxes, for example, under which employers are generally required to withhold (and remit to the U.S. Treasury) payroll taxes from the wages of their *employees* and also pay a matching payroll tax contribution equal to the employee portion of the tax.[9] Employers are similarly obligated to pay a federal unemployment tax on all wages;[10] withhold income taxes from the wages paid an *employee*;[11] and furnish *employees* with W-2 forms summarizing their wages.[12]

The determination of common law status is based on a multi-factor test that has its origins in tort law as a basis for recovery from the master for torts committed by his servant during the course of the servant's employment.[13] The factors are catalogued in the ''20-factor'' test set forth in Rev. Rul. 87-41.[14] The Supreme Court, in *National Mutual Insurance Co. v. Darden*,[15] subsequently whittled down the 20-factor test to 13 factors.[16] The IRS has since modified Rev. Rul. 87-41 for training purposes in its ''Worker Classification Training Guidelines: Employee or Independent Contractor'' (October 1996).[17] Instead of 20 or 13 factors, the training guidelines prescribe three, broad standards — behavioral control, financial con-

[6] 29 USC §§1001 et seq.

[7] Treas. Regs. §31.3401(c)-1(a).

[8] Treas. Regs. §31.3401(c)-1(b).

[9] Code §§3102(a) and 3111. For a discussion of the employment tax rules, see Allman, 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation*.

[10] Code §3301. However, Code §3302 provides for a partial credit against an employer's Federal Unemployment Tax Act (''FUTA'') obligations for certain state unemployment tax contributions (e.g., payments made to the Massachusetts Department of Employment and Training for the unemployment compensation payroll tax).

[11] Code §3402. The withholding rules do contain some exceptions that are intended to facilitate the tax collection process. Under Code §3401(d), the person for whom an individual performs services as an employee is the employer, unless that person lacks control over the payment of the wages, in which case the person in control of paying wages is considered the employer.

[12] Code §6051(a).

[13] *See* Restatement (Second) of Agency §§219, 220 (1958) (imposing liability on the master based on his presumed control over the actions of his servant).

[14] 1987-1 C.B. 296. The 20 factors are: instructions; training; integration; services rendered personally; hiring, supervising, and paying assistants; continuing relationship; set hours of work; full time required; doing work on employer's premises; order of sequence set; oral or written reports; payment by hour, week, month; payment of business and/or traveling expenses; furnishing of tools and materials; significant investment; realization of profit or loss; working for more than one firm at a time; making service available to general public; right to discharge; and right to terminate.

[15] 503 U.S. 318 (1992).

[16] *Id.* at 327. The 13 factors are the hiring party's right to control the manner and means by which the particular result is to be accomplished; the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent to which the hired party may decide when and how long to work; the method of payment; the role of the hired party in hiring and paying assistants; whether the work is part of the hiring party's regular business; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party.

[17] The Training Guidelines are reproduced in Marmoll, 391 T.M., *Employment Status — Employee vs. Independent Contractor*, Worksheet 14.

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trol and legal control — for determining whether a worker is an independent contractor or an employee.

(b) ERISA

In a perfectly circular fashion, ERISA §3(6) defines ''employee'' to mean ''any individual employed by an employer.'' ''Employer'' is in turn defined in ERISA §3(5) to mean ''any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan . . . .'' Intentionally or not, Congress left it to the courts to flesh out the definition. That opportunity presented itself to the Supreme Court in *Darden* (discussed immediately above), in which the Court held that, for purposes of applying the safeguards accorded employee benefits under ERISA, whether an individual is an employee (and thus entitled to the protections that ERISA affords) is determined under the common law employee standard.[18]

(c) Common Law vs. Other Tests

Common law employer status is key to determining whether an entity is obligated to comply with a host of tax and benefit requirements, including whether a worker must be considered for non-discrimination testing under a tax-qualified retirement plan, and who is responsible for payroll taxes and withholding at the source, and the accompanying reporting obligations. The primary factor in determining an individual's status as an employee under common law is whether the entity purporting to be the employer has the right to control *both the result the worker is to accomplish and the means by which such result is to be accomplished*. For tax and benefits purposes, the common law test is generally used to identify a single employer. There generally is no such thing as co-employment or joint employment, although the Code does, in limited cases, recognize the concept of ''concurrent employment.''[19]

The one-employer outcome of the common law test in tax and benefits cases stands in marked contrast to most employment laws which generally apply different, more expansive standards to establish employee status, and which often recognize that an individual may simultaneously be the employee of more than one employer. In non-tax or benefits cases, the predominant test of employee status is the ''economic realities'' test, which looks to the extent a worker is economically dependent on the employer rather than the degree of control exercised or exercisable by the employer. The greater the degree of economic dependence, the less likely a worker is self-employed. Co- or joint-employment is commonly found under economic realities-type analysis, generally under statutes that are remedial in nature. Examples include the Fair Labor Standards Act,[20] the Occupational Safety and Health Act,[21] and Title VII of the Civil Rights Act.[22]

II. STAFFING FIRMS, PEOs, AND ''LEASED EMPLOYEES''

(a) The Staffing Firm Model

Staffing firms recruit, screen, and hire workers from the general labor market and assign them to end user businesses (generally referred to as ''client organizations'') usually for limited periods of time. Contract and temporary workers retained through staffing firms typically support or supplement the client organization's work force; provide assistance in special work situations such as employee absences, skill shortages, and seasonal workloads; and perform special assignments or projects. When the assignments are completed, the staffing firm customarily attempts to reassign the employees to the same or other clients. Staffing firm services include a wide range of human resource functions such as skills assessment, training and upgrading, risk management, and payroll and benefits administration. Many staffing firms also supply employees to work on longer-term, indefinite assignments. Those employees are recruited, screened, and assigned in essentially the same manner as in the case of temporary employees. Long-term staffing can involve just one or a few individuals, or it can involve a significant portion of the staff required to operate a specific client function.

In the typical staffing firm model, clients can request that a worker be reassigned or can discontinue the services, but cannot affect the employment rela-

[18] 503 U.S. at 323.

[19] 78 Fed. Reg. 6056, 6057 (1/29/13). As explained in the preamble to a 2013 proposed regulation under Code §3504: ''In unique circumstances, an individual may be an employee of more than one employer (concurrent employment) with regard to the same services. *See* Rev. Rul. 66-162, 1966-1 C.B. 234 (citing Rest. 2d Agency §226). In order for an individual to be concurrently employed by two entities, each entity must separately satisfy the common law control test.

[20] *See generally*, *Krause v. Cherry Hill Fire District 13*, 969 F. Supp. 270 (D.N.J. 1997) (providing statutory basis for determining employee status). The FLSA should be read broadly in pursuit of its remedial purpose such that certain volunteer firefighters are ''employees'' for FLSA purposes notwithstanding the limited exception contained in 29 USC §203(e)(4)(A) relating to individuals that receive no compensation. *Id.*

[21] *See Rockwell Int'l Corp.*, 17 OSHA (BNA) 1801 (1996).

[22] *Compare*, *Knight v. United Farm Bureau Mut. Ins. Co.*, 950 F.2d 377, 380 (7th Cir. 1991) (applying economic realities test in determining insurance agent was independent contractor and not employee), *with Deal v. State Farm County Mut. Ins. Co.*, 5 F.3d 117, 118–19 (5th Cir. 1993) (using hybrid economic realities/ common law right-of-control test in holding that agent was employee and not independent contractor). *See also Amarnare v. Merrill Lynch*, 770 F.2d 157 (2d Cir. 1985), *Reith v. TXU Corp.*, 2006 BL 47869 (E.D. Tex. 2006); *Magnuson v. Peak Technical Services*, 808 F. Supp. 500 (E.D. Va. 1992). For a general overview of co-employment issues in non-tax and benefits cases, *see* Lenz, *Co-employment: Employer Liability Issues in Third-Party Staffing Arrangements*, 7th ed. (American Staffing Association, 2011).

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tionship with the staffing firm. Staffing firms also routinely require workers to adhere to certain policies and procedures governing the workers' conduct; and they have the right to discipline the workers, including terminating the employment relationship with the staffing firm.

(b) Professional Employer (Employee Leasing) Organizations

The terms ''employee leasing'' or ''staff leasing'' has been a source of confusion. They are sometimes used generically to describe any form of third-party personnel service arrangements; but their origins lie in a specific kind of service arrangement used in structuring certain retirement plans. These terms first came into public view during the late 1960s and throughout the 1970s, when certain professional groups took advantage of what were referred to as ''staff leasing'' arrangements. The arrangements were used by certain professionals to establish pension or profit-sharing plans for themselves and avoid the Code's coverage and nondiscrimination tests. Some early staff leasing arrangements were upheld[23] and, as a result, became increasingly prevalent until Congress ended the practice through a number of tax law changes beginning in 1982.

Staff leasing involved what generally was referred to as a ''fire and leaseback.'' The client, e.g., one or more doctors, would ''fire'' the staff employees who then would be ''hired'' by the leasing firm and ''leased'' back to the doctor. Since the staff ostensibly was no longer employed by the doctors, the latter were free to establish generous retirement plans for themselves without having to include the staff when applying the Code's coverage and non-discrimination tests.

Congress effectively ended these ''fire and leaseback'' practices by amending the Code to require service recipients to include ''leased employees'' as defined in Code §414(n) when applying those tests to the recipient's benefit plans. Code §414(n) defines ''leased employee'' as any employee who is *not* the common law employee of the recipient (i.e., the client organization) and who has performed services for the recipient on a substantially full-time basis for at least one year. This definition is so broad that it could be construed to apply to virtually any individual performing services for a recipient. Reacting to complaints from professional employee groups that the provision was overbroad, Congress amended the Code in 1996 to exclude from the definition of leased employee individuals who regularly make use of their own judgment and discretion on important matters in the performance of their services (e.g., lawyers, accountants, computer programmers, and engineers).[24] Nevertheless, Code §414(n) continues to cover a much broader range of service providers than the staff leasing firms whose activities were the primary reason for the legislation.

After Code §414(n) was enacted, the staff leasing industry shifted the direction of their businesses to assuming payroll and other employer responsibilities mostly for small to mid-sized businesses. The purpose was to mitigate the clients' burden of complying with myriad employment laws and allowing them to focus on running their businesses. To reflect this new direction, staff leasing companies began to call themselves ''professional employer organizations'' (PEOs) and, in 1993, the industry trade group formally changed its name from the ''National Staff Leasing Association'' to the ''National Association of Professional Employer Organizations.'' Unlike temporary staffing, employee leasing is widely regulated at the state level. While more recent laws have adopted the term PEO to describe those services, earlier laws still use employee leasing.

There are material operational differences between staffing firms and PEOs. A central difference is that, in contrast to staffing firms, PEOs typically do not recruit and hire employees from the general labor market, but instead assume employer responsibilities for all or most of a client organization's *existing* workforce. Under PEO arrangements, the employment relationship between the client organization and its workers does not change because the client retains day-to-day control over the workers in carrying on its trade or business. For *employment law* purposes — but not for tax and benefits purposes — the PEO becomes a joint- or co-employer.[25] This distinction is sometimes overlooked, particularly when PEOs seek to sponsor and make available employee benefit programs to worksite employees.

Under Code §401(a)(2), a tax-qualified retirement plan must be maintained for the exclusive benefit of the sponsor's employees and their beneficiaries. Before 2002, it was not uncommon for PEOs to maintain a single 401(k) retirement plan covering both the PEO's in-house staff and the client organization's worksite employees. But if worksite employees are common law employees of the client organization, then such a plan would run afoul of the exclusive benefit rule under Code §401(a)(2). PEOs claimed that they satisfied the exclusive benefit rule because the worksite employees were the employees of both the PEO and the client organization — i.e., co-employees.

In Rev. Proc. 2002-21,[26] the IRS effectively rejected the PEOs' claim, determining that retirement plans established and maintained by PEOs must be treated as multiple employer plans under Code §413(c)(2). A multiple employer plan is a plan maintained by two or more unrelated employers, that is employers who are not treated as under common con-

[23] *See, e.g., Packard v. Commissioner*, 63 T.C. 621 (1975).

[24] *See* Small Business Job Protection Act of 1996, H.R. Rep. 104-737, at 124 (1996).

[25] There are, of course, other common law doctrines, such as ''borrowed servant'' or ''dual employment,'' but the Treasury Department and IRS are not necessarily bound by those doctrines when interpreting and applying the Federal tax code.

[26] 2002-19 I.R.B. 911.

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trol, under Code §§414(b) (relating to controlled groups), 414(c) (relating to trades or businesses under common control), or 414(m) (prescribing rules for affiliated service groups).[27] Rev. Proc. 2002-21 notably makes no mention of co-employment, nor does it identify the employer of the worksite employees. But the implications are clear: in the IRS's view, worksite employees are the common law employees of the client organization and not the PEO.[28] This view is arguably overbroad since it does not take into account the facts and circumstances of particular cases. As discussed below, recent judicial authority provides support for the position that employee leasing firms (PEOs) can satisfy the common law employer test, at least in some circumstances.[29]

Rev. Proc. 2002-21 did not address welfare benefits, but a medical plan maintained by a PEO that covers the PEOs permanent staff and individuals employed at client organization worksites raises similar issues. Accordingly, such a plan will in all likelihood constitute a multiple employer welfare arrangement or MEWA.[30] And, indeed, many of the large commercial PEOs are organized, and report, as such.[31] ERISA §3(40) defines the term ''multiple employer welfare arrangement'' to mean:

> [A]n employee welfare benefit plan, or any other arrangement (other than an employee welfare benefit plan) which is established or maintained for the purpose of offering or providing [welfare benefits] to the employees of two or more [unrelated] employers (including one or more self-employed individuals), or to their beneficiaries, . . .

Self-funded MEWAs are subject to state law.[32] Though fully insured MEWAs are also subject to some state regulation, states are largely constrained in their ability to regulate fully insured MEWAs.[33] Some states require self-funded MEWAs to be organized as a licensed insurance company. Others (those with separate MEWA regulations) do not require self-funded MEWAs to be so licensed but generally only if the MEWA is sponsored by a tax-exempt entity.[34] PEOs that provide medical benefits under a MEWA typically do so under fully insured arrangements. Fully insured MEWAs may involve additional issues if small groups are involved, since some state insurance codes prohibit combining multiple small groups (which are subject to small group underwriting rules) into a single large group (which is not).[35]

III. CODE §4980H, EMPLOYER SHARED RESPONSIBILITY

(a) Code §4980H Overview

The basic structure of the ACA's employer shared responsibility has by now become generally familiar to the affected applicable large employers. The term ''applicable large employer'' means ''an employer who employed an average of at least 50 full-time employees on business days during the preceding calendar year.''[36] While ''full-time equivalent employees'' must be counted in determining ''applicable large employer'' status, employer penalties (''assessable payments'') under Code §4980H (discussed below) are based on full-time employees only.[37] The Act provides that a ''full-time employee'' with respect to any month is an employee who is employed on average at least 30 hours of service per week.[38]

Beginning in 2015,[39] each applicable large employer is subject to an assessable payment under Code §4980H(a) or (b) if any full-time employee is certified as eligible to receive an applicable premium tax credit or cost-sharing reduction from a public insurance exchange.

Code §4980H(a) Liability

Section 4980H(a) liability arises if the employer fails to offer its ''full-time employees'' (and their de-

[27] Treas. Regs. §1.413-2(a)(2).

[28] The revenue procedure omits ''co-employment'' as a possible solution when providing an alternative framework to avoid plan disqualification due to violation of the exclusive benefit rule.

[29] *See* Janich, *Contingent Workers and Employee Benefits, in ERISA Litigation* 1389, 1435 n.207 (BNA 2008) (explaining that licensing requirements for PEOs have been enacted in a number of states making the PEO the legal employer or co-employer of worksite employees).

[30] *See* ''Multiple Employer Welfare Arrangements under the Employee Retirement Income Security Act (ERISA): A Guide to Federal and State Regulation,'' published by the U.S. Department of Labor, Employee Benefits Security Administration, available at: http://www.dol.gov/ebsa/pdf/mwguide.pdf (explaining the regulation of MEWAs). The DOL has determined that a PEO's welfare benefit plan was a MEWA where the PEO was unable to demonstrate that all the individuals covered by the plan were not exclusively common-law employees of the PEO. DOL Advisory Op. 95-29A (12/7/95). *See also* March 1, 2006 Department of Labor Information Letter to George J. Chanos, Attorney General, Nevada Department of Justice, available at: http://www.dol.gov/ebsa/regs/ILs/il050806.html (holding that the PEO and its clients would not be considered a single employer even though the PEO had agreements with each of its clients under which the PEO had an option to purchase an 80% interest in each client company, because the options arrangements were shams).

[31] ERISA §101(g). MEWAs are generally required to file a form M-1 annually. Information contained on Form M-1s is available at: http://askebsa.dol.gov/epds.

[32] ERISA §514(b)(6). However, the DOL has opined that federal law, and not a state PEO law, governs the determination of whether a particular arrangement is a MEWA. DOL Advisory Op. 2007-05A (8/15/07).

[33] *Id.*

[34] *E.g.,* Me. Rev. Stat. tit. 24-A, Chapter 81.

[35] *See, e.g.,* 211 Code Mass. Regs. §66.04 (defining ''Eligible Small Business or Group'' for purposes of the Massachusetts small group market).

[36] Code §4980H(c)(2)(A).

[37] Code §4980H(c)(2)(E).

[38] Code §4980H(c)(4)(A).

[39] IRS Notice 2013-45, 2013-31 I.R.B. 116.

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pendents) the opportunity to enroll in ''minimum essential coverage'' under an ''eligible employer-sponsored plan.'' Under this provision, if an employer fails to make an offer of coverage to at least 95% of its full-time employees, an assessable payment is imposed monthly in an amount equal to $166.67 multiplied by the number of the employer's full-time employees, excluding the first 30.[40]

Code §4980H(b) Liability

Section 4980H(b) liability arises if the employer offers its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan that, with respect to a full-time employee who qualifies for a premium tax credit or cost-sharing reduction, either (i) is unaffordable or (ii) does not provide minimum value. If the employer makes the requisite offer of coverage, the assessable payment is equal to $250 per month multiplied by the number of full-time employees who qualify for and receive a premium tax credit or cost-sharing reduction from a health insurance exchange.[41] The amount of the Code §4980H(b) liability is capped at the Code §4980H(a) liability amount.[42] As a result, an employer that offers group health plan coverage can never be subject to a larger assessable payment than that imposed on a similarly situated employer that does not offer group health plan coverage.

''Minimum essential coverage'' includes coverage under an ''eligible employer-sponsored plan.'' An ''eligible employer-sponsored plan'' includes ''group health plans offered in the small or large group market within a state'' but does not include ''excepted benefits'' as defined and described under the Public Health Service Act, e.g., stand-alone vision or dental benefits, most medical flexible spending accounts, hospital indemnity plans, etc.[43]

Employer-provided health insurance coverage is deemed ''unaffordable'' if the premium required to be paid by the employee exceeds 9.5% of the employee's household income. The IRS in prior guidance proposed a safe harbor under which affordability is determined on the basis of an employee's income as reported on his or her Form W-2 (in Box 1) instead of household income. The substitution of W-2 income for household income is referred to as the ''affordability safe harbor.''[44]

Coverage is deemed to provide ''minimum value'' if it pays for at least 60% of all plan benefits, without regard to copays, deductibles, co-insurance, and employee premium contributions. The IRS in prior guidance established rules for determining minimum value based on guidance issued by the Department of Health and Human Services relating to actuarial value.[45]

(b) The Proposed §4980H Regulations

The proposed §4980H regulations endeavor to fill in many of the details required to implement Code §4980H. Prop. Treas. Regs. §54.4980H-1(a)(13) defines the term ''employee'' under Code §4980H to mean ''an individual who is an employee under the common-law standard.'' That provision includes a cross-reference to Treas. Regs. §31.3401(c)-1(b) cited above (describing the control-based standards to be applied to establish common law employee status). This definition has prompted concerns on the part of some employers and their advisors that temporary and contract employees provided by staffing firms and PEOs will, for Code §4980H purposes, generally be treated as common law employees of the client organization. These concerns are misplaced in our view.

The preamble to the proposed regulations expressly recognizes that a ''temporary staffing agency'' can be a common law employer under the ACA.[46] A temporary staffing agency refers to an ''entity that is the common law employer of the individual that is providing services to a client of the temporary staffing agency.''[47] The preamble cites Rev. Rul. 70-630[48] as ''an illustration of the facts and circumstances under which a temporary staffing agency (rather than its client) is the individual's common law employer.''[49]

Rev. Rul. 70-630 addressed whether sales clerks trained by an employee service company and furnished to a retail store to perform temporary services for the store were common law employees of the service company. The service company trained and placed individuals to perform sales services in conformity with the established procedure of the retail store. The service company placed a supervisor in each store to determine whether the clerks who had been assigned were ''neat in appearance and dressed in accordance with the store's regulations.'' The clerks provided weekly time cards to the service company after it had been approved by the store. The store did not have the right to demand any particular clerk, but was required to accept the clerks assigned to it. If the service of any clerk was unsatisfactory, the store could ask that the clerk be reassigned elsewhere. On these facts, the IRS ruled that clerks were the common law employees of the service company. In arriving at this conclusion, the IRS was persuaded that ''the employee service company has the right to direct and control the sales clerks to the extent necessary to establish the relationship of employer and employee under the usual common law rules.'' Although staffing firms typically do not, as in this case, place supervi-

[40] Code §4980H(a), (c)(1); Prop. Treas. Regs. §54.4980H-4.

[41] Code §4980H(b)(1).

[42] Code §4980H(b)(2).

[43] Code §5000A(f)(2).

[44] Prop. Treas. Regs. §54.4980H-3(b).

[45] The HHS calculator is available at: http://www.cms.gov/cciio.

[46] 78 Fed. Reg. 218, at 230.

[47] *Id.*

[48] 1970-2 C.B. 229.

[49] 78 Fed. Reg. 218, at 230.

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sors at the client's worksite, this is not necessary to establish the staffing firm's common law employer status provided other substantial indicia of control are present as discussed below.[50]

(c) Common Law Employer Status Under §4980H — Temporary Staffing vs. PEO

Historically — both in theory and for the most part in practice — employees assigned by staffing firms and those employed under PEO arrangements have been treated differently with respect to their common law status. The former have generally been considered common law employees of the staffing firm; the latter are generally viewed as the common law employees of the client organization. While we are unaware of any judicial authority that explicitly examines the distinction, it is reflected in widespread industry practice. Notably, however, recent federal court rulings, discussed below, have upheld the common law employer status of both staffing firms and PEOs.

Staffing firms operating under the traditional temporary staffing model should generally qualify as common law employers for Code §4980H purposes because they typically satisfy more than enough of the salient factors under the multifactor test. These include recruiting, screening, and hiring the workers; assuming responsibility as employer of record for payment of wages and benefits and for withholding and paying employment taxes; establishing employment policies governing employee job performance and conduct; and exercising the right to discipline, terminate, or reassign the employees. Those factors are also present in newer forms of staffing in fields that include information technology, finance, engineering, and health care. Employees assigned to those jobs generally work for longer periods, are more highly skilled and paid, and as a consequence are more apt to be offered (and participate in) staffing firm-sponsored benefit plans.

Few court rulings have explicitly dealt with the common law status of staffing firms or PEOs.[51] The most recent, *Blue Lake Rancheria v. United States*,[52] is particularly significant, both because of the level of judicial authority and because the facts in the case mirror facts that are typical of most staffing firm operations as well as many PEO arrangements. The case involved a claim by an employee leasing company (PEO) wholly owned by an Indian tribe for a payroll tax exemption under a provision of the Code[53] which excepts "services performed in the employ of an Indian tribe" from the definition of "employment" for purposes of unemployment taxes (i.e., FUTA). The appellant, Blue Lake Rancheria, established Mainstay Business Solutions as a for-profit business owned by and operated for the benefit of the tribe. Mainstay provided employee leasing and temporary staffing for small and medium-sized businesses located in California, Hawaii, and Nevada. The case involved only the tribe's employee leasing operations, which the court characterized as follows:

> Mainstay contracted with each of its clients to hire the client's employees as its own and then 'lease' those employees back to the client. The client supervised the leased employees on a day-to-day basis, but Mainstay paid their wages, provided benefits, and performed other human resources functions. According to Mainstay, this arrangement allowed the client to free itself from H.R. responsibilities and focus on its business, and resulted in better benefits for employees.[54]

The claim arose when the tribe filed for a refund of approximately $2 million in unemployment taxes paid by Mainstay. The tribe claimed that the workers employed by the employee leasing company satisfied the requirements for the exemption under Code §3306(c)(7). Reversing the district court, the United States Court of Appeals for the Ninth Circuit agreed with the tribe, holding that the employee leasing company and not the client organization was the common law employer. The employee leasing company was, therefore, entitled to the exemption from employment taxes as an instrumentality of the tribe. Addressing the absence of direct worksite supervision by Mainstay, the court noted:

> Although the client, not Mainstay, supervised the leased employees on a day-to-day basis, the employees were required to comply with Mainstay's employment policies regarding such issues as smoking, telephone use, timekeeping, and breaks. In this sense, the leased employees were subject to the will and control of both Mainstay and the client company.[55]

Even though the Ninth Circuit found sufficient evidence of control by Mainstay despite the client's day-to-day supervision of the actual work being performed, control issues are so central to common law analysis that it may be prudent for entities utilizing staffing firms to require that the staffing firms include

[50] *See also* Rev. Rul. 75-41 (holding that a staffing firm was the common law employer on facts that are more typical of a traditional staffing arrangement).

[51] *See, e.g., Burrey v. Pac. Gas & Elec. Co.*, No. 4-95-cv-04638-DLJ (N.D. Cal. 5/12/99) (holding that the staffing firm was a common law employer based on facts similar to those described above).

[52] 653 F.3d 1112 (9th Cir. 2011).

[53] Code §3306(c)(7).

[54] *Blue Lake Rancheria*, 653 F.3d at 1114.

[55] *Id.* at 1120.

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language in their staffing agreements conferring a broad staffing firm right to control the employees' activities at the worksite, even if that right will rarely be exercised.[56] Such language, in addition to the actual performance by the staffing firm of the myriad other employer functions enumerated earlier in this article, arguably should establish the staffing firm's common law employer status beyond reasonable dispute.

(e) Placement and "Temp-to-Perm" Arrangements

Staffing firms often provide direct placement of workers, along with arrangements that start as temporary but lead to permanent employment, usually after a relatively short, fixed period of time (e.g., three months). In the case of placement-only services, the worker is directly hired by the client and once hired becomes the common law employee of the client organization.[57] In such cases, there is no "worksite employee" to be concerned with. In so-called "temp-to-perm" arrangements, the assigned employee should be viewed as the common law employee of the staffing firm under the principles described above during the "temp" phase of the arrangement.

(f) Special Case — Payrolling

Some staffing firms provide "payrolling" services, which present unique issues under Code §4980H. In the typical payrolling arrangement, a staffing firm simply manages the payroll for a subset of the current employees of a client organization in a manner similar to the services provided by a PEO. Based on the provisions of the proposed §4980H regulations cited above, and the IRS's historical view of the employer status of PEOs, payrollees might well be viewed as the common law employees of the client organization. But this result ignores a long history of law and practice.

The common law standard that applies for §4980H purposes is in all material respects the same common law standard that applies to retirement and welfare plans. If the rules governing common law employee status were strictly applied to payrolling arrangements, then any retirement plans covering payrollees would be multiple employer plans and any welfare plans would be MEWAs. While some PEOs have adopted the MEWA approach, we are not aware of any instance where a staffing firm has done so. Nor are we aware of any enforcement action against a staffing firm based on the failure to do so. To do so would overturn years of established industry practice. This is both unnecessary and unwarranted.

Requiring a staffing firm to bifurcate its workforce by treating payrollees as the common law employee of the client organization while treating temporary and contract workers as the common law employees of the staffing firm would lead, in the authors' view, to unnecessary complexity and confusion without any tangible benefit. Doing so leads to the inescapable conclusion that retirement plans and welfare plans that cover payollees are, respectively, multiple employer plans and MEWAs. While we concede that the underlying legal analysis might be less than satisfying, the pre-ACA rules work: workers are treated as employees of *someone* and not independent contractors; benefit programs are generally nondiscriminatory; carriers are willing to underwrite fully insured group health plans without fear of running afoul of applicable state insurance market rules; and stop-loss issuers, third-party administrators, and a host of other service providers, are willing to provide services to self-funded group health plans without fear that they may be complicit in the violation of state insurance laws.

Because they are in the "people business," most staffing firms are applicable large employers for Code §4980H purposes. These firms will either extend coverage or pay any applicable penalties. If a firm fails to extend coverage to a sufficient number of full-time permanent staff, contract and temporary employees, and payrollees, they will be subject to the excise tax under Code §4980H(a), which will include payrollees; if they make the requisite offer of coverage but that coverage is either unaffordable or insufficiently generous, they will pay the penalties imposed under Code §4980H(b), with respect to which the multiplier will include payrollees who timely apply and qualify for a premium tax credit.

There are, of course, instances in which staffing arrangements in general, and payrolling, in particular, might be abused. A client organization with, for example, 65 full-time employees could payroll 16 of these employees primarily to avoid applicable large employer status. Situations of this sort could be identified and addressed with an anti-abuse rule of the sort envisioned in the preamble to the proposed regula-

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[56] *See also Castiglione v. U.S. Life Insurance Co.*, 262 F. Supp. 2d 1025 (D. Ariz. 2003) (holding that a leasing company, rather than the company to which the leasing company leased employees, was the employer for ERISA purposes). In *Castiglione*, the leasing company agreed to ensure the recipient company's adherence to federal, state, and local tax laws, payroll, workers' compensation laws and to provide group health and life insurance. *Contrast Professional & Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225, 8 EBC 2153 (1987), *aff'd*, 862 F.2d 751, 10 EBC 1627 (9th Cir. 1988) (holding that a "management" leasing company operated by the petitioner was not the common law employer). In a reverse of the classic leasing arrangement that led to the enactment of §414(n), the petitioner approached owners of small professional practices such as medical doctors and offered to hire them and then lease them back to their professional corporations or businesses. The arrangement resulted in a rich benefit package to the professionals from which their employees were excluded. The court held that the professionals were not employees of the leasing company, primarily because the leasing company exercised no meaningful control over them.

[57] *But see* Prop. Treas. Regs. §54.4980H-3 (relating to the look-back measurement period method for assessing full-time employee status of new variable hour, new seasonal, and ongoing employees); and Prop. Treas. Regs. §54.9815-2708. It is not yet clear whether the service during the "temp" and "perm" periods must be tacked for purposes of counting hours, or for purposes of measuring group health plan eligibility waiting periods.

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tions.[58] In situations that are not abusive, however — i.e., in which compliance with Code §4980H is unaffected, or where there are bona fide business reasons for entering into the staffing arrangement unrelated to Code §4980H — we can discern no compelling policy reason to treat the client rather than the staffing firm as the employer provided that the staffing firm offers ACA-compliant coverage (or pays the required penalties in lieu of coverage).

IV. A PROPOSED REGULATORY SOLUTION

The added complexity and uncertainty associated with the application of the common law employer test in third-party employment situations calls for a practical way to make employer responsibility determinations for purposes of §4980H — especially in the case of payrolling arrangements — that does not involve upsetting decades of industry practice.

Assessable payments under Code §4980H(a) and (b) are predicated on whether an applicable large employer ''fails to offer to its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan (as defined in §5000A(f)(2)).'' Code §5000A(f)(2) defines the term ''eligible employer-sponsored plan'' to mean, ''with respect to any employee, a group health plan or group health insurance coverage offered by *an* employer to the employee.'' (Emphasis added.) The definition leaves open the possibility that coverage offered by a staffing firm could be deemed an offer by the client organization with the staffing firm acting as the client's agent. Indeed, such a proposal has already been suggested.[59]

Nor do we see any legal or policy reason for dispensing with the agency analysis if the staffing firm elects to pay an excise tax penalty in lieu of offering coverage. Section 4980H explicitly gives employers the option of paying excise taxes in lieu of offering coverage. Thus, if a staffing firm elects not to offer ''minimum essential coverage'' to at least 95% of its full-time employees (or offers minimum essential coverage that either is not affordable or does not provide ''minimum value'') and instead pays any resulting excise taxes that are assessed with respect to the employees assigned to a client, the staffing firm should be viewed as having acted as an agent on the client's behalf and the client should not have responsibility with respect to those employees even if it is found to be the common law employer.

CONCLUSION

The common law employee test depends on applying a series of factors to the particular facts and circumstances of individual cases, which in many instances are ambiguous. This is the antithesis of a bright-line test. When applied to distinguish between an employee and an independent contractor, the best that can be said of this multi-factor test is that it is ''workable.'' But when used to determine whether a staffing firm, PEO, or client organization is the employer to the exclusion of the others, the test can be subjective in the extreme.

It should surprise no one that a long-standing practical rule has emerged for making common law employee determinations in three-party settings: Staffing firms for decades have assumed responsibility as employers for myriad employment, labor, and benefits law obligations — it has become a hallmark of the staffing business. That assumption has been left undisturbed presumably because it has worked. In the case of temporary workers, the application of the common law standard is straightforward. The same is generally true in the case of longer-term contract assignments. This leaves a handful of other arrangements, including payrolling, in which staffing firms have reflexively been presumed to be the common law employer for tax and benefits purposes.

Some staffing firms and their clients are now concerned that the same common law standard they have relied upon for decades under other prior law may be construed differently for Code §4980H purposes. This is a problem for staffing firms and their clients, to be sure, but it is also a problem for the IRS field agents and others who are tasked with day-to-day enforcement of provisions of the tax code that depend on correctly ascertaining common law employee status. Particularly in cases where the facts are ambiguous, the agency approach that we outlined above dispenses with the need to apply this test.

We cannot predict whether the common law test will be applied strictly, or whether the regulators will adopt a more practical ''no harm, no foul'' approach. We urge the latter, of course, based on our conviction that there is nothing wrong with the status quo ante that needs to be fixed, and that the solution described above would protect staffing firms and their clients in a manner fully consistent with the legal and policy objectives of the ACA.

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[58] 78 Fed. Reg. 218, at 230.

[59] *See* ''Applicability of Affordable Care Act to Joint Employers,'' 41 *Comp. Plan. J.* 124 (5/3/13) (reporting that IRS is considering an approach under which the client would not be subject to penalty if an employee accepts an offer of coverage by the PEO or leasing organization that ''satisfies the conditions of §4980H,'' and that the IRS ''is looking further into this [§4980H agency] issue, although it is unlikely to be addressed in the final regulations'').

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