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Tax Management Memorandum™

The Final Code §4980H Regulations; Common Law Employees; and Offers of Coverage by Unrelated Employers

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The Patient Protection and Affordable Act (ACA) added Code §4980H to the Internal Revenue Code (''Code''), thereby governing ''shared responsibility for employers regarding health coverage.''[2] Under these rules, each ''applicable large employer'' must make an offer of group health plan coverage to its full-time employees or face the prospect of a penalty.[3] In a two-party employment arrangement, involving an employer and an employee, identifying which individuals qualify as 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 final regulations published in the Federal Register on February 12, 2014 (the ''final regulations''),[4] the Treasury Department and the Internal Revenue Service (IRS) established a rule under which 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, though not always perfectly, consistent with applicable tax laws and doctrines. Regulators rarely challenged this operating premise, however. 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. Whether this approach will continue for ACA's employer shared responsibility requirements purposes is not yet clear. We believe that there are compelling legal and policy reasons that it should.

In this article we seek to establish that, based on long-standing 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 separately examine a provision of the final regulations — governing ''offer[s] of coverage on behalf of another entity''[5] — under which, for purposes of Code §4980H, an offer of coverage made by a staffing firm to full-time workers placed with a cli-

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[2] Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), *amended by* (i) the Health Care and Education Reconciliation Act of 2010 (HCERA), Pub. L. No. 111-152, 124 Stat. 1028 (2010), (ii) the TRICARE Affirmation Act, Pub. L. No. 111-159, 124 Stat. 1123 (2010), (iii) the Medicare and Medicaid Extenders Act of 2010, Pub. L. No. 111-309, 124 Stat. 3285 (2010), (iv) the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, Pub. L. No. 112-9, 125 Stat. 36 (2011), (v) the Department of Defense and Full-Year Continuing Appropriations Act, 2011, Pub. L. No. 112-10, 125 Stat. 38 (2011), and (vi) the 3% Withholding Repeal and Job Creation Act, Pub. L. No. 112-56, 125 Stat. 711 (2011) (collectively, the ''ACA'' or ''Act'').

[3] *See* below §III.A (discussing and defining ''applicable large employer'').

[4] Shared Responsibility for Employers Regarding Health Coverage, T.D. 9655, 79 Fed. Reg. 8544 (Feb. 12, 2014) (to be codified at 26 C.F.R. pts. 1, 54, 301).

[5] Treas. Reg. §54.4980H-4(b)(2).

ent organization is treated as an offer of coverage by the client organization provided certain other requirements are satisfied. While this rule will aid significantly (and legitimately) in the quest by staffing firms and client organizations to comply with Code §4980H, it raises several potential complications in instances in which an employee is determined, on examination or audit, to be the common law employee of the client organization rather than the staffing firm.

Section I below provides an overview of who is a ''common law'' employee.[6] It also contrasts the common law employee test from other tests used to determine employee status. 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'' (PEOs). Section II also explains and provides historical context for understanding the term ''leased employee.'' In Section III, we explore the overall impact of Code §4980H and the final regulations on staffing firms and PEOs. Section IV dissects the rules governing offers of coverage on behalf of another entity, and Section V offers a summary of our conclusions and recommendations.

I. THE COMMON LAW (AND OTHER TESTS) OF EMPLOYEE STATUS

Identifying employers and employees is essential to the application of a broad range of federal, state, and local laws governing employment, tax, benefit, and other subjects with a wide range of policy objectives. Laws governing workplace safety, for example, tend to define the terms ''employer'' and ''employee'' broadly, as do state laws governing workers' compensation. For these and other purposes it is not uncommon for more than one entity to be the employer under doctrines such as ''joint employment.''[7] For federal tax benefits and other purposes, Congress and the courts have taken a different tack. Specifically, both the Employee Retirement Income Security Act of 1974 (ERISA) (for employee benefits purposes) and the Code (for federal tax purposes) determine employee status by applying the ''common law agency'' or, simply, the ''common law'' test.[8] Thus, the common law employee test is applied to determine 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.

Importantly, for purposes of this paper, the status of a worker as an employee for purposes of Code §4980H is determined by applying the common law test.[9]

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.''[10]

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,[11] the Occupational Safety and Health Act,[12] and Title VII of the Civil Rights Act.[13] As we conclude later, applying some variation of co-

[6] *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).

[7] *See, e.g.,* Americans with Disabilities Act of 1990, Pub. L. No. 101-336 (Jul. 26, 1990) (codified at 42 U.S.C. 12101 et seq.).

[8] 29 U.S.C. §§1001 et seq.

[9] Treas. Reg. §54.4980H-1(a)(15), §54.4980H-1(a)(16) (defining the terms ''employee'' and ''employer,'' respectively).

[10] 78 Fed. Reg. 6056, 6057 (Jan. 29, 2013). 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.

[11] *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 U.S.C. §203(e)(4)(A) relating to individuals that receive no compensation. *Id.*

[12] *See Sec'y of Labor v. Rockwell Int'l Corp.*, 17 O.S.H. Cas. (BNA) 1801 (OSHRC 1996).

[13] *Compare Knight v. United Farm Bureau Mut. Ins. Co.*, 950

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employment analysis for Code §4980H purposes could resolve a number of thorny implementation issues.

A. ERISA

ERISA Section 3(6) defines ''employee'' (in a perfectly circular fashion) to mean ''any individual employed by an employer.'' ''Employer'' is in turn defined in ERISA Section 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 *National Mutual Insurance Co. v. Darden*, 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.[14]

B. 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.''[15] 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. . . .[16] (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.[17] Employers are similarly obligated to pay a federal unemployment tax on all wages;[18] withhold income taxes from the wages paid an *employee*;[19] and furnish *employees* with W-2 forms summarizing their wages and employment tax withholdings.[20]

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.[21] The factors are catalogued in the ''20-factor'' test set forth in Rev. Rul. 87-41.[22] In *Darden*, the Supreme Court subsequently whittled the 20-

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 generally* Lenz, *Co-employment: Employer Liability Issues in Third-Party Staffing Arrangements* (7th ed. 2011).

[14] *National Mutual Insurance Co. v. Darden*, 503 U.S. 318, 323 (1992).

[15] Treas. Reg. §31.3401(c)-1(a).

[16] Treas. Reg. §31.3401(c)-1(b).

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

[18] 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).

[19] 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.

[20] Code §6051(a).

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

[22] 1987-1 C.B. 296 (establishing the following 20 factors: 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;

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factor test down to 13 factors.[23] The IRS has since modified Rev. Rul. 87-41 for training purposes in its ''Worker Classification Training Guidelines: Employee or Independent Contractor'' (Oct. 1996).[24] Instead of 20 or 13 factors, the training guidelines prescribe three, broad standards — behavioral control, financial control and legal control — for determining whether a worker is an independent contractor or an employee.

C. Treasury and IRS Guidance

In a series of revenue rulings and Chief Counsel memoranda, the IRS has provided useful insight into how it thinks the common law employee test ought to be applied in three-party arrangements. The bulk of these arise in the context of employment taxes, wherein an employer's tax obligations or entitlement for a refund depend on who is the common law employer. These revenue rulings and Chief Counsel memoranda are both useful because they apply the same common law employee standard to which the final regulations refer. Thus, they may be valuable as precedent or a guide to the IRS's thinking in the matter. (Revenue rulings can be relied upon as precedent by all taxpayers; but Chief Counsel memoranda cannot be used or cited as precedent.)

Because it is cited in the preamble to the proposed regulations, Rev. Rul. 70-630[25] bears scrutiny. According to the preamble, this ruling serves 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.''[26] 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 they 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.[27] 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.''[28] Although staffing firms typically do not, as in this case, place supervisors 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.[29]

Two earlier rulings shed some additional light. Rev. Rul. 56-502 reached a result similar to Rev. Rul. 70-630, ruling that a domestic service agency that engaged workers to perform services for its clients was the employer.[30] In so ruling, the IRS noted that:

> (1) the agency was engaged in the business of furnishing such services and so held itself out to the general public; (2) the agency furnishes the employment of the individuals and fixes their remuneration; (3) the clients for whom the services were performed looked to the agency for duly qualified and trained individuals; (4) the services were necessary to the conduct of the agency's business and promoted or advanced its business interests; and (5) the total business income of the agency was derived through a percentage of the remuneration received by the individuals for the performance of their services

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).

[23] *See Darden*, 503 U.S. at 327 (listing the following 13 factors: 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).

[24] The Training Guidelines are reproduced in Worksheet 12 in Marmoll, 391 T.M., *Employment Status — Employee vs. Independent Contractor*.

[25] 1970-2 C.B. 229.

[26] 78 Fed. Reg. 218, at 230.

[27] Rev. Rul. 70-630, 1970-2 C.B. 229.

[28] *Id.*

[29] *See also* Rev. Rul. 75-41, 1975-1 C.B. 323 (staffing firm was the common law employer on facts that are more typical of a traditional staffing arrangement).

[30] Rev. Rul. 56-502, 1956-2 C.B. 688, *modified by* Rev. Rul. 80-365, 1980-2 C.B. 300 (''[t]he general rule for determining employee status set forth in Rev. Rul. 56-502 only applies to sitting services if the agency pays the sitters directly'').

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Chief Counsel Advice Memorandum (CCA) 200827007 offers a stark contrast to Rev. Rul. 70-630. At the outset, the memorandum explains that, although the taxpayer "describes its business as a 'staffing company,' [t]axpayer operates in a like manner to businesses commonly called . . . [a] professional employer organization . . . ."[31] According to the memorandum:

> Taxpayer operates in form not uncommon for employee leasing companies. When a business hires the Taxpayer, it fires its employees one day, and the next day leases those same employees from Taxpayer. From the affected employees' perspective there is no change in their relationship with the client company. The client company continues to control the daily performance of its workers' duties. Taxpayer does not provide employees with any specific instructions as to when, where or how the work will be done.[32]

At issue in this CCA was the taxpayer's practice of aggregating and reporting all its clients' FICA and FUTA (i.e., Forms 941, Employer's Quarterly Federal Tax Return and Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return reporting wages) under its own name based on the position that it, and not any client company, was the common law employer. The IRS disagreed, holding instead that the taxpayer is not the common law employer of the individuals performing services for taxpayer's clients. In so concluding, the IRS observed:

> A common law employer/employee relationship exists between an entity and individuals when the entity has the right to direct and control the performance of services by the individuals. . . . When a business hires the Taxpayer, it fires its employees one day, and the next day leases those same employees from Taxpayer. From the affected employees' perspective there is no change in their relationship with the client company. The client company continues to control the daily performance of its workers' duties. Taxpayer does not provide employees with any specific instructions as to when, where or how the work will be done. Taxpayer has hundreds of clients spread across multiple states.[33]

Field Service Advice (FSA) 200023006 presents a particularly rich trove of evidence of the IRS's views on identifying the common law employer in a three-party arrangement in the context of a claim for a refund of employment taxes — i.e., FICA, FUTA, and income tax withholding.[34] In contrast to CCA 200827007, which involved an employee leasing company/professional employer organization, the taxpayer in FSA 200023006 appears to be a more traditional staffing firm, i.e., the taxpayer:

> maintains numerous indicia of common law employer status regarding the worksite employees, e.g., [Taxpayer] pays the employees, withholds and pays all payroll taxes, provides workers' compensation coverage, provides certain employee benefit programs, is involved in the hiring/firing process, hears and acts on complaints from the employees about working conditions and oversees workplace safety issues, etc. In addition to retaining a right to direct and control the employees, [Taxpayer] also exercises sufficient rights of control that it should be recognized as the co-employer of such individuals.

On these facts, the IRS determined that the taxpayer, and not the client organization, is the common law employer, saying that:

> The material submitted by the taxpayer in connection with its refund claims does not establish that it was not the common law employer of the workers. To the contrary, the taxpayer asserted common law employer status. The taxpayer has therefore not established its entitlement to a refund.

Taken together, these rulings, GCMs and FSAs evince an important, though sometimes overlooked point: the determination of common law employer status arises independent of the label attached to the employer. Calling an employer a professional employer organization as opposed to a staffing firm is not determinative because these terms have no independent legal significance. Ultimately, the common law test will govern employer status based on the specific facts and circumstances. But that test, as explained above, is highly subjective and difficult to apply in the three-party context. As a result, in the practical world of the regulators, labels, while not conclusive, have

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[31] CCA 200827007.

[32] *Id.* (footnotes omitted).

[33] *Id.* (footnotes omitted). The IRS relied heavily on the U.S. Court of Federal Claims decision in *Cencast Services, L.P. v. United States*, 62 Fed. Cl. 159 (2004), *aff'd*, 729 F.3d 1352 (Fed. Cir. 2013).

[34] Code §3101–§3128, §3301–3311, §3401–3405, respectively.

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nonetheless come to mean something; or, at least, they appear to have, as we endeavor to explain below.

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

A. The Staffing Firm Model

Staffing firms generally 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 relationship 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" have been a source of much 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 and, as a result, became increasingly prevalent until Congress ended the practice through a number of tax law changes beginning in 1982. [35]

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).[36] 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, em-

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

[36] *See* Small Business Job Protection Act of 1996, H.R. Rep. No. 104-737, at 124 (1996).

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ployee 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 the employees recruited and hired by a client organization at the client's worksite. 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.[37] 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, 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).[38] A multiple employer plan is a plan maintained by two or more unrelated employers; that is, employers who are not treated as under common control 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).[39] 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.[40] 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.[41]

Rev. Proc. 2002-21 did not address welfare benefits, but a medical plan maintained by a PEO that covers the PEO's 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.[42] And, indeed, many of the large commercial PEOs are organized, and report, as such.[43] 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. . . .[44]

[37] 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.

[38] Rev. Proc. 2002-21, 2002-19 I.R.B. 911.

[39] Treas. Reg. §1.413-2(a)(2).

[40] 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.

[41] *See* Janich, *Contingent Workers and Employee Benefits, in ERISA Litigation* 1389, 1435 n.207 (Jayne E. Zanglein and Susan J. Stabile eds., 3d ed., 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).

[42] *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 (Dec. 7, 1995). *See also* Information Letter from Department of Labor to George J. Chanos, Attorney General, Nevada Department of Justice (Mar. 1, 2006), *available at* http://www.dol.gov/ebsa/regs/ILs/il050806.html (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).

[43] Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, §101(g), 88 Stat. 829 (codified as amended in scattered sections of 5 U.S.C., 18 U.S.C., 26 U.S.C., 29 U.S.C., and 42 U.S.C.). MEWAs are generally required for file a Form M-1 annually. Information contained on Form M-1s is available at: http://askebsa.dol.gov/epds.

[44] ERISA §3(40).

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Self-funded MEWAs are subject to state law.[45] Though fully insured MEWAs are also subject to some state regulation, states are largely constrained in their ability to regulate fully insured MEWAs.[46] Some states require self-funded MEWAs to be organized as a licensed insurance company. Others (those with separate MEWA regulations) require self-funded MEWAs to be so licensed only if the MEWA is sponsored by a tax-exempt entity.[47] 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).[48]

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.''[49] 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.[50] 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.[51]

Unless transition relief is available,[52] each applicable large employer is subject to an assessable payment under Code §4980H(a) or §4980H(b) beginning in 2015 if any full-time employee is certified as eligible to receive, and does receive, an applicable premium tax credit or cost-sharing reduction from a public insurance exchange.[53]

1. Code §4980H(a) Liability

Section 4980H(a) liability arises if the employer fails to offer its ''full-time employees'' (and their dependents) 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 percent 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.[54]

2. 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 is (i) 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.[55] The amount of the Code §4980H(b) liability is capped at the Code §4980H(a) Liability amount.[56] 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.[57]

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 deter-

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[45] 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 (Aug. 15, 2007).

[46] *Id.*

[47] *E.g.,* Me. Rev. Stat. tit. 24-A, ch. 81 (1996).

[48] *See, e.g.,* 211 Mass. Code Reg. §66.04 (2011) (defining ''Eligible Small Business or Group'' for purposes of the Massachusetts small group market).

[49] Code §4980H(c)(2)(A).

[50] Code §4980H(c)(2)(E).

[51] Code §4980H(c)(4)(A).

[52] Preamble, Final Regulations, §XV, 78 Fed. Reg. 8569–8577.

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

[54] Code §4980H(a), §4980H(c)(1); Prop. Treas. Reg. §54.4980H-4, 78 Fed. Reg. 218 (Jan. 2, 2013).

[55] Code §4980H(b)(1).

[56] Code §4980H(b)(2).

[57] Code §5000A(f)(2).

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mined 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.''[58]

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.[59]

B. The Final Regulations

Treas. Reg. §54.4980H-1(a)(15) defines the term ''employee'' for Code §4980H purposes to mean:

> [A]n individual who is an employee under the common-law standard. See §31.3401(c)-1(b). For purposes of this paragraph (a)(15), a leased employee (as defined in section 414(n)(2)), a sole proprietor, a partner in a partnership, a 2-percent S corporation shareholder, or a worker described in section 3508 is not an employee.

[58] Prop. Treas. Reg. §54.4980H-3(b).

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

This definition invites the question of whether temporary and contract workers provided by staffing firms and PEOs to client organizations will, for Code §4980H purposes, be treated as common law employees of the staffing firm or the client organization. The final regulations complicate this inquiry by referring to and conflating the terms ''staffing firm'' and ''professional employer organization'' in the context of the rule (discussed in Section IV below) relating to ''offers of coverage on behalf of another entity.'' Under this rule, a client organization may be given credit for an offer of coverage made by ''a professional employer organization or other staffing firm (in the typical case in which the professional employer organization or staffing firm is not the common law employer of the individual).''

The final regulations do not further explain or otherwise elucidate the ''typical' case in which the professional employer organization or staffing firm is not the common law employer, and the reference to professional employer organizations and staffing firms is at odds with the long-standing industry position, and apparent regulatory view, described above. Further complicating the analysis, elsewhere (in a rule relating to the determination of an employee's status as a ''variable hour'' employee) the final regulations refer to a ''temporary staffing firm.''[60] The following table summarizes our understanding of the differing views:

[60] Treas. Reg. §54.4980H-3.

	Temporary Staffing Firm	**Staffing Firm**	**Professional Employer Organization**
Industry View	Temporary staffing firm generally is the common law employer	Staffing firm generally is the common law employer	Client organization is the common law employer*
(Apparent) IRS View	Temporary staffing firm generally is the common law employer	Client organization generally is the common law employer	Client organization is the common law employer
*The ''industry view'' of PEOs as not the common law employer is based on Rev. Proc. 2002-21. But there is judicial authority to the contrary as discussed below.			

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C. Common Law Employer Status Under Code §4980H — Temporary Staffing v. 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.

Few court rulings have explicitly dealt with the common law status of staffing firms or PEOs.[61] The most recent, *Blue Lake Rancheria v. United States*,[62] 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 which excepts ''services performed in the employ of an Indian tribe'' from the definition of ''employment'' for purposes of unemployment taxes (i.e., FUTA).[63] 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.[64]

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 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.[65]

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 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.[66] Such language, in addition to the actual performance by the staffing firm of the myriad other

[61] *See, e.g., Burrey v. Pac. Gas & Elec. Co.*, 1999 U.S. Dist. LEXIS 22619 (N.D. Cal. May 12, 1999) (holding that the staffing firm was a common law employer based on facts similar to those described above), *on remand from* 159 F.3d 388 (9th Cir. 1998).

[62] *Blue Lake Rancheria v. United States*, 653 F. 3d 1112 (9th Cir. 2011).

[63] Code §3306(c)(7).

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

[65] *Id.* at 1120.

[66] *See also Castiglione v. U.S. Life Insurance Co.*, 262 F. Supp. 2d 1025 (D. Ariz. 2003) (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) (''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 Code §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

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employer functions enumerated earlier in this article, arguably should establish the staffing firm's common law employer status beyond reasonable dispute.

D. Short- and Long-Term Temporary Employees and Assignments

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 the 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. Rev. Rul. 70-630 is consistent with this view.

Those multifactor test 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. Though the case for common law employee status of these latter, longer term employees is less certain than in the case of short-term, high-turnover placements, it is nevertheless still compelling. And even if this is a much closer case, the parties retain at the margins the power to control the outcome based on the structure of the arrangement and the contractual terms under which it operates.

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., 3 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.[67] 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 our 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 payrollees 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 non-discriminatory; carriers are willing to underwrite fully insured group health plans without fear of running afoul of applicable state insurance

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from which their employees were excluded. The court ruled that the professionals were not employees of the leasing company, primarily because the leasing company exercised no meaningful control over them.

[67] *But see* Treas. Reg. §54.4980H-3(d) (relating to the look-back measurement period method for assessing full-time employee status of new variable hour, new seasonal, and ongoing employees); and Treas. Reg. §54.9815-2708 (relating to the limits on waiting periods imposed by Public Health Service Act §2708 as added by the Act). 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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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.

G. What Is at Stake?

Because they are in the so-called ''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. For example, a client organization with 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 regulations.[68] 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. OFFERS OF COVERAGE ON BEHALF OF ANOTHER ENTITY

The final regulations include a provision under which, if certain requirements are satisfied, an offer of coverage by a ''professional employer organization or other staffing firm'' to an employee performing services for a client organization is treated as an offer of coverage for Code §4980H purposes made by the client organization.[69] The need for such a rule is perhaps best illustrated by an 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).

In order to qualify for the special rule governing offers of coverage by unrelated employers, the final regulations require that ''the fee the client employer would pay to the staffing firm for an employee enrolled in health coverage under the plan is higher than the fee the client employer would pay to the staffing firm for the same employee if the employee did not enroll in health coverage under the plan'' (the ''fee requirement'').[70] The contours of this requirement have caused some confusion, and will likely need to be fleshed out in subsequent guidance. While the fee is not required to bear any particular relationship to the cost of coverage, it is not clear how the fee must be stated or charged. Must each election of coverage be reflected in a separate line-item for each employee? If so, clients might be encouraged to request only employees who do not elect coverage. A more practical option would be to simply aggregate the cost of coverage for all enrolled employees and include it in the client's bill rate.

The final regulations neither explain nor furnish a rationale for the fee requirement. But we understand from informal remarks of Treasury and IRS officials that they deemed the fee requirement to be necessary to preserve consistency with other provisions of the Code. Simply put, if group health plan coverage is provided by the staffing firm, but the covered em-

[68] 78 Fed. Reg. 218, 230.

[69] Treas. Reg. §54.4980H-4(b)(2).

[70] *Id.*

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ployee is the common law employee of the client, then the employee will be unable to exclude reimbursements of medical expenses under Code §105(b); he or she will not qualify for the deduction for employer-provided group health plan premiums under Code §106(b); and his or her employee contributions will not satisfy the requirements of Code §125. The employer deduction for ordinary necessary business expenses under Code §162 and §262 would also be affected. Absent the fee requirements, staffing firms offering group health plan coverage to workers who are not their common law employees would be denied the business expense deduction.

Where the client organization satisfies the fee requirement, the plan under which the coverage is provided is deemed to be one to which the client organization contributes. If one follows the presumed logic of the fee requirement, therefore, the IRS views the plan as a multiemployer plan. It is, after all, a plan covering employees of two or more unrelated employers. The portion of the plan covering the employees placed by the staffing firm is, in effect, sponsored by the client organization. For staffing firms that have historically viewed themselves as common law employers and who invoke the rules governing offers of coverage by unrelated employers and its accompanying fee requirement — either prophylactically to address client concerns at the outset of an arrangement, or on later audit or examination — raise a number of concerns:

(1) *MEWA status of the staffing firm's group health plan*

As we explained above, if the employees placed with a client organization are covered under the staffing firm's group health plan and the staffing firm is determined not to be the common law employer, then that plan is, and is regulated as, a multiple employer welfare plan. 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. If the plan under which the staffing firm makes the offer of coverage 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.

(2) *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 deducible 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. Code §125(d)(1) defines the term ''cafeteria plan'' to mean a written plan under which ''all participants are employees.'' The term ''employee'' in each case refers to the common law standard. 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. Worse, under a literal reading of Code §125, the staffing firm's cafeteria plan fails to qualify as such for anyone. If it was determined on audit or examination that employees who the staffing firm treated as their common law employees were the common law employees of the client organization, then these deductions and exclusions would be disallowed for the open tax years, and payroll tax adjustments would be required.

(3) *Impact on other benefit plans and programs*

If a staffing firm determines in advance of entering into an agreement with a client organization that the employees being placed under the agreement are common law employees of the client, then other benefit programs may be affected. 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. The problems that would arise on audit are similar though even more daunting, since the plan may already have one or more qualification failures that could only be corrected under the audit closing agreements program (rather than under the much preferred voluntary correction program or a self-correction program).

(4) *Possible claims under ERISA for benefits*

Employees who are placed with a client organization and are subsequently determined to be common law employees of the client

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organization might have a valid claim for benefit under the group health plan of the client organization in a manner reminiscent of the case brought some years ago against Microsoft Corporation.[71] Indeed, it was the result of employees being reclassified for employment tax purposes that led to claims being brought under ERISA and the Code in that case. Presumably, client organizations might begin to amend their group health plans and other benefit plans to include ''4980H'' inoculation language that would expressly exclude these employees.

[71] *See Vizcaino v. U.S. Dist. Court for W. Dist. of Wash.*, 173 F.3d 713, 23 EBC 1209 (9th Cir. 1999); *see also Vizcaino v. Microsoft Corp.*, 120 F.3d 1006, 21 EBC 1273 (9th Cir. 1997), *modifying* 97 F.3d 1187 (9th Cir. 1996), *cert. denied*, 522 U.S. 1098 (1998).

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(5) *Where to draw the line*

The staffing arrangements in III.D., E., and F., above, (relating short- and long-term temporary employees and assignments, placement and "temp-to-perm" arrangements, and payrolling) fall roughly, though not perfectly, on a continuum. At one end of the continuum is low job security/high turnover found in the context of "temporary staffing" in the narrowest sense of the phrase. At the other end of the continuum is long-term job security of the sort represented by PEO. The middle of the continuum is occupied by longer-term assignments in such fields as information technology, finance, and engineering among others. But where does one draw the line? At some point do workers cease being common law employees of the staffing firm and become common law employees of the client organization, merely because of the passage of time? That cannot be the right test because it would implicate every service firm that provides employees to perform services on a long-term basis for other businesses — e.g., landscape contractors, building maintenance, food service, and security protection services, to name just a few, all of which are often performed under some degree of supervision and control by the client business.

If a staffing firm determines their payrollees are common law employees of the client organization, then what effect does this have on their contact workers with long assignments? Are these latter workers common law employees of the staffing firm or the client organization? As the assignments get shorter and more irregular, at what point does a worker cease being the common law employee of the client organization? The answer in each case is to apply the common law employee standard. But that standard is ill-suited, in our view, to the practical task of making this call in three-party arrangements. The identity of the common law employer nevertheless remains critically important. It impacts not only the types of medical plans the staffing firm or client organization might offer, it also affects retirement benefits provided to their respective employees. (Would a 401(k) plan covering these folks be a single employer plan or a multiple employer plan, for example?)

Although Treasury and IRS officials apparently intended the fee requirement to preserve consistency with other provisions of the Code, the language of the fee requirement itself does not address the provisions of Code §105(b), §106 or §125(d)(1) — much less the MEWA issues discussed above. The problem is structural: it flows from the exclusionary nature of the common law rule, under which there is only one employer and one employee.

A different definition of "employee" for Code §4980H purposes — i.e., one that is broad enough to encompass co-employment — might provide a solution. This approach was recognized in *Vizcaino v. U.S. Dist. Court for W. Dist. of Wash.*,[72] wherein the Ninth Circuit suggested in dicta that co-employment is not incompatible with administration of the laws governing tax and benefits. Applying some variation of co-employment for Code §4980H purposes would have the salutary effect of sidestepping the problems identified above, with no discernible increase in opportunities for abuse. In a three-party arrangement, the employer *or* the staffing firm would offer coverage or face the prospect of an assessable payment. Either way, the Code §4980H incentives to offer coverage are preserved in full.

V. 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 perhaps "workable" though cumbersome. 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.

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 cor-

[72] 173 F.3d 713, 723–4 (9th Cir. 1999).

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rectly ascertaining common law employee status. 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.

ISSN 0148-8295

ISSN 0148-8295