Contingent Workers: Is the Staffing Agency or the Client Employer Liable under the Employer Mandate?

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The Issues

Many employers hire temporary and contract workers (often called “contingent workers”) from staffing agencies. Some workers are hired on a short-term temporary basis, while others are hired for longer-term projects or even indefinitely. Since the “employer mandate” provisions of the Affordable Care Act (ACA) will soon apply, a critical issue for both staffing agencies and “client employers” who hire contingent workers is: Which party is the common law employer of these workers?

The short answer is that the final regulations suggest:

- “Temporary: staffing firms” - Generally will be the common law employer of the workers they place on temporary or short-term assignment at various client employers.
- “Other” staffing firms and PEOs - Typically the client employer will be the common law employer.

This is a critical issue because a common law employer who is an “applicable large employer” (ALE) risks being subject to significant penalties (under IRC section 4980H) unless it offers health coverage to substantially all full-time employees. (Generally, an ALE is an employer who employed on average at least 50 full-time employees or full-time equivalents during the prior calendar year, but for 2015 the threshold is 100 rather than only 50.) The penalties could skyrocket for an ALE who is audited several years after the mandate has been in effect if the IRS re-classifies workers as common law employees, and the ALE had not included them in its prior calculations of whether it was meeting ACA requirements.

This article is written for both staffing agencies and the client employers who hire workers through staffing agencies. It explains the applicable provisions in the ACA, the different types of staffing firms, the “common law” employment test, and the guidance provided in the final regulations regarding staffing firms and client employers –including a safe harbor and several special rules.

Background: Applicable ACA Provisions

The “employer mandate” provisions for which ALEs must count employees in their calculation of whether the employer is meeting ACA requirements are:

- In 2015 the ALE must “offer coverage” to at least 70% of all full-time employees and dependents (but not to part-time employees or full-time equivalents). This increases to 95% after 2015.
The common law employer also must determine which newly-hired employees are full-time and which are variable hour or seasonal employees, because this affects if and when they must be offered health coverage.

- If a non-compliance penalty applies, it applies only to the entity that is deemed to be the common law employer. There is no “co-employer” liability under the employer mandate; either the staffing agency or the client employer will be liable.

**Final Regulations – Provisions on Staffing Agencies**

The final regulations (issued February 10, 2014) provide much clarity, but leave some issues unresolved. Below is a summary of the guidance provided in the final regulations, and the rest of this article provides additional detail.

- The final regulations differentiate between temporary staffing firms and other staffing firms including Professional Employer Organizations (PEOs). The regulations suggest that:

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- The final regulations do not provide safe harbor relief if an employer misclassifies a worker as the common law employee of another employer, and the IRS later determines the worker is a common law employee of the first employer. This means an employer could be liable retroactively for penalties from prior years.

- If the “client employer” is the common law employer (such as in the PEO situation), the final regulations provide a safe harbor method by which the staffing agency or PEO can provide health benefits to workers on behalf of the client employer.

- The final regulations require employers to use the Monthly measurement method (rather than the Look-back measurement method) for new hires who are “reasonably expected” at date of hire to be full-time; and list factors the employer (whether it’s the staffing firm or client employer) can consider to determine whether or not a new-hire is a full-time employee.

**Different Reasons Employers Hire through Staffing Firms**

Employers hire workers through staffing agencies for many different reasons, so there are many different types of staffing arrangements and contracts. In some cases, the client employer meets most of the important factors under the “common law” employment test (discussed below), and in other cases the staffing firm meets more of the factors. This is the reason it is difficult (if not impossible) for the regulators to come up with one rule that applies to all staffing arrangements. Additionally, the IRS expressed concern (in the Preamble to both the proposed and final regulations) that black-and-white distinctions may result in some employers attempting to “game” the system to avoid the obligation to offer coverage to full-time workers. (For example, by hiring
employees directly for 20 hours per week and hiring the same employees through a staffing agency for 20 hours per week, so neither employer would have an obligation to offer coverage or pay a penalty.)

Some employers hire short-term temporary workers to fill in for employees who are on short-term leaves of absence, or to work on special projects or unusually large orders. Other employers hire workers through staffing firms to fill positions that are longer-term or indefinite assignments. Still other employers recruit particular employees but then have them hired through a PEO which handles payroll and other employer responsibilities and places the workers on-site at the client employer for an indefinite or long-term period. This is often the case for specialized workers such as IT or engineering or finance/tax professionals. Another variation on this theme is that the PEO assumes payroll and other employer responsibilities for all or most of a client employer’s existing workforce. Until the early 1990’s this was known as “staff leasing.”

**Different Types of Staffing Firms: “Temporary,” “Other” and PEOs**

Some staffing firms are only in the “temporary worker” business, others place both short-term temporary and longer-term workers, still others are only the PEO or “staff leasing” model, and some staffing firms include both a temporary worker division and a PEO division. There are significant operational differences between a temporary staffing firm and a PEO or “staff leasing” firm.

**Temporary staffing firms** generally recruit workers from the general labor pool, screen and hire them, and place them on short-term or longer-term assignments with client employers who are unrelated to the staffing firm. When an assignment ends, the staffing firm usually tries to place the temporary worker with another employer or in another temporary position at the same employer. Workers have the right to accept or reject temporary jobs the staffing agency offers. Likewise, client employers can accept or reject particular workers that are assigned to them, but they generally do not determine whether a particular worker will be terminated from employment with the staffing agency. Only the staffing firm has the right to fire the worker, to discipline or impose sanctions, or to control the worker’s behavior by requiring compliance with employment policies and procedures.

**PEOs**, on the other hand, generally do not recruit and hire workers from the general labor pool, nor do they place workers on assignment with various client employers. Instead, as noted above, the PEO usually assumes payroll and other employer responsibilities for a client employer’s existing workforce or for recruits the client employer selects and sends to the PEO to hire. The client employer retains the right to discipline and terminate these long-term workers and also retains day-to-day control over how and where workers perform their jobs. The PEO and client employer become “joint employers” or “co-employers” for employment law purposes, but not for tax or benefits purposes (so not for ACA purposes).

The Final regulations differentiate between “temporary” and “other” staffing firms (including PEOs) when it comes to which employer will be the “common law” employer and thus liable to “offer coverage” or face potential penalties. The regulations suggest that a “temporary” staffing firm will be the common law employer of the workers it places on temporary or short-term assignment at various client employers, but that “other” staffing firms and PEOs typically will not be the common law employer of the workers they place at client employers. Instead, the client employer will be the common law employer.

(See note at the end of this InDepth on HCR, on an excellent article with additional detail on staffing firms and the common law employment test.)
Common Law Employment Test

The reason the final regulations make the distinction between different types of staffing firms is because the IRS believes temporary staffing firms generally meet enough of the factors under the standard “common law” employment test, and PEOs generally do not. The common law employment test originated in tort law and has been articulated by the IRS (in Rev. Ruling 87-41, 20-factor test), numerous court decisions (the Supreme Court in National Mutual Insurance Co. v. Darden (1992) specified 13 factors) and in IRS training guidelines (specifying three areas of control: behavioral, financial and legal).

The basic common law employment test is whether the employer (or which employer) “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 the result is accomplished.” (Treasury Regs. 31.3401(c)-1(b).) Other factors include the right to train, supervise, discipline and discharge the worker.

As noted above, the temporary staffing agency meets most of the requirements of a “common law” employer because it hires, trains, supervises, has the right to direct and control the individual (through the policies and procedures it sets, and through its placement of the workers at various client employers), and has the right to terminate the employment relationship. The PEO, on the other hand, does not have most of these rights. Instead, the client employer recruits particular workers (but sends them to the PEO to be hired or payrolled), trains them, has day-to-day control over their behavior, and has authority to terminate the employment relationship.

It is particularly important that both client employers and staffing agencies correctly determine which entity will be the common law employer because, as noted above, the final regulations do not provide safe harbor relief if the client employer misclassifies a worker as the common law employee of the staffing firm (or vice-versa), and the IRS later determines the worker is a common law employee of the first employer. This is a departure from the “section 530 relief” available under the Revenue Act of 1978, which protected employers from after-the-fact liability for employment taxes if the employer had a good faith “reasonable” basis for classifying certain workers as independent contractors.

Thus, under the ACA final regulations, a client employer could become liable after the fact for penalties under IRC 4980H if a worker who should have been considered a full-time employee (and offered coverage) was instead considered an employee of the staffing agency, was not offered coverage, bought health insurance in the public exchange or marketplace and received a subsidy to do so. This could also work in reverse if the staffing agency considers the client employer to be the common law employer, and the staffing agency is subsequently deemed the common law employer.

➢ **Practical Note:** Even if the contract between the staffing agency and the recipient employer includes elements intended to indicate (or even specifically states) which entity the parties intend to be the “common law” employer, the IRS or DOL could subsequently find otherwise. For example, the final regulations indicate that the IRS generally considers the staffing agency to be the common law employer of “temporary” workers who are placed at unrelated third party employers for short-term (and even longer-term) assignments. If the staffing contract specified the opposite (that the recipient employer was the common law employer) or that the recipient employer had day-to-day control over the workers, there is no guarantee the IRS would agree with that designation, particularly if the recipient employer failed to offer coverage to the temporary full-time workers. The result could be disastrous for the temporary agency, because it could be liable for penalties for prior years.
Safe Harbor: PEO Can Offer Health Coverage on Behalf of Client Employer

The final regulations provide a new safe harbor rule: A staffing agency or PEO that is not the common law employer can offer health coverage to a worker on behalf of the client employer who is the common law employer. If the staffing firm offers an employee coverage in the staffing firm’s health plan, on behalf of the client employer, the coverage is treated as coverage offered by the client employer (for pay-or-play purposes) but only if the client employer pays a higher fee to the staffing agency or PEO for an employee enrolled in health coverage than for the same employee if the employee did not enroll.

The safe harbor sounds fairly straightforward and is intended to protect the client employer from potential penalties, but there are many questions as to how it will apply in practice. Many staffing firms meet the IRS definition of both “temporary” and “other” firms (including PEOs), so would be the common law employer for some of its workers but not for others. Some workers move between short-term and long-term positions, so might sometimes seem to fit the category of common law employees of the staffing agency and other times of the client employer. For workers who consistently are on short-term temporary assignments, the final regulations seem to deem the staffing agency as the common law employer. In all these situations, it may be administratively easier for the staffing company to simply offer its health plan to all contingent workers and offset the cost by increasing rates uniformly for all workers.

The problem is that under the safe harbor the client employer must pay a higher fee to the staffing agency or PEO for an employee enrolled in health coverage than for the same employee if the employee did not enroll. However, the safe harbor does not require that the higher fee be equal to the actual cost (or any percentage of the actual cost) of the coverage. It may be possible for the staffing firm or PEO to spread the cost of coverage among all client employers and then to charge a nominal additional amount (perhaps only $1 per week?) for those employees who are enrolled in coverage.

Alternatively, since one of the goals of the ACA is to increase access to coverage, it might make sense for the IRS to issue additional regulations that provide for an alternative:

- allow all staffing agencies to offer contingent workers coverage under a staffing agency plan that provides at least minimum value and is affordable,
- do not require that client employers pay more for employees who are enrolled than those who are not, and
- provide in the nondiscrimination rules (that are not yet issued) that client employers need not include contingent workers in their nondiscrimination testing as long as the contingent workers are offered affordable minimum value coverage by the staffing agency.

This would allow employers to continue offering their existing health plan to their regular employees, even if the existing health plan had a higher employer contribution and higher actuarial value than the staffing company’s health plan for contingent employees. This seems to be the same rule that applies for an employer who has collectively bargained employees who are offered affordable minimum value coverage through the union plan pursuant to a bargaining agreement or other participation agreement.
How to Determine Whether a New-Hire is a Variable Hour or Full-Time Employee

On the issue of whether a new hire is a full-time employee or a variable hour employee, the final regulations list factors an employer can consider in making this determination. They also list additional factors a temporary staffing firm can consider in making this determination, if the staffing firm is the common law employer. The final regulations do not adopt a generally applicable presumption that new employees of a temporary staffing firm are either variable hour employees or full-time employees for purposes of the look-back measurement period. (Preamble section VII.C.7.)

Practical Note: As a result of the factors and the lack of a presumption (noted above), and the measurement method provisions (explained immediately below), employers who want to hire short-term temporary employees may be more likely to hire them through a temporary agency, since the agency will be the employer for purposes of the employer mandate. This makes it particularly critical for staffing agencies to properly classify new-hires as “reasonably expected” to work full-time or not.

The reason it matters whether a new hire is a full-time or variable hour employee is because for an employee who is “reasonably expected” at date of hire to work full time, a “special rule” in the final regulations requires the employer to use the “monthly” measurement method and to offer health coverage by the first day of the month after three calendar months of full-time employment (or by the 91st day under the Waiting Period regulations). This applies even if the new employee is in a category of employees for whom the employer generally uses the “look-back” measurement method.

A slight digression is in order here: A separate provision in the final regulations requires employers to use the same measurement method (either “monthly” or “look-back” method) for all employees in the same category. The regulations specify only four permissible categories:

- Hourly-paid employees or salaried employees
- Collectively bargained or non-collectively bargained employees
- Employees in each separate bargained group if there are several different groups
- Employees whose primary places of employment are in different states

For example, even if an employer elects to use the look-back method for hourly employees, the special rule in the final regulations requires the employer to use the monthly method for newly-hired hourly employees who are reasonably expected at date of hire to be full time. Under the look-back measurement method, an employer may track hours during the initial measurement period and does not have to offer coverage until the associated stability period (possibly 13-14 months later) and then only if the employee was full-time during the initial measurement period. However, an employer cannot require a new full-time employee to wait that long for an offer of coverage.

The final regulations list the following factors an employer can use to determine whether a new hire is a full-time employee or a variable hour employee. The employer can also consider additional factors, and no one factor is determinative.

- Whether the new employee is replacing an employee who was a full-time or a variable hour employee
- Whether the hours worked by employees in the same or similar positions have actually varied above and below an average of 30 hours per week in recent measurement periods
• Whether the position was advertised, or otherwise communicated to the new employee or otherwise documented (for example, through contract or a job description) as requiring on average more or less than 30 hours per week, or variable hours.

The final regulations specify that one factor the employer may not take into account is whether it is likely the employee will terminate employment before the end of the initial measurement period (for example, because most workers in this position only remain for a short time).

The final regulations list the following additional factors a temporary staffing firm can use to determine whether a new hire is a full-time employee or a variable hour employee. The agency also can consider other factors, and no one factor is determinative. A staffing agency would apply this analysis if the agency is the common law employer and hires employees for placement at a client employer who is not the common law employer. It seems under the final regulations that temporary staffing agencies can make the new-hire determination based on the employment position for which a new employee is hired, rather than on an employee-by-employee basis. This is because the regulations say a staffing agency can consider whether employees in the same position of employment with the staffing agency:

• have the right to reject temporary placements the temporary agency offers
• typically have periods during which no offer of temporary employment is made
• typically are offered temporary jobs for differing periods of time, and
• typically are offered temporary jobs that do not last beyond 13 weeks. (Under the break in service rules, if an employee has no hours of service for at least 13 weeks and then returns to work, the employer can treat the employee as a new employee rather than a continuing employee, and can disregard hours worked prior to the break in service.)

Thus, for example, a temporary staffing agency might determine that most new hires for Security Guard positions are reasonably expected to work full-time, but most new hires for Administrative Assistant are not reasonably expected to work full-time, based on the above factors.

➢ Practical Note: If a temporary staffing firm does determine that certain employees are “reasonably expected” to work full-time—even if the employees will be placed in various short-term assignments at different client employers – this means the staffing firm will have to start offering coverage by the 91st day. In order to stay in business, staffing firms must charge client employers more than it costs the staffing firm to provide the contingent workers, so the cost of coverage will be added on to the hourly rate for temporary workers.

Short-term Employees and High-turnover Positions

Newly-hired employees in short-term and high-turnover positions are two categories of new-hires that many employers (both staffing firms and client employers) would like to treat as variable hour or seasonal (rather than full-time) employees, so they can track the employees’ hours during the initial measurement period and not have to offer coverage until the associated stability period (13-14 months later), and even then, only if the employee still works for the employer by that time. However, the final regulations do not adopt any special rules for short-term employees or high-turnover positions, because the IRS is concerned about the potential for abuse of any exception. In fact, as noted above, the final regulations specify that one factor the employer may not take into account—in determining whether a new-hire is full-time or not—is whether it is likely the
employee will terminate employment before the end of the initial measurement period (for example, because this is a high-turnover position).

Short-term employees are those who are expected to average at least 30 hour per week for less than 12 months, but are not doing seasonal work expected to recur on an annual basis. High-turnover positions are those in which a significant percentage of employees can be expected to terminate in a short period of time, such as during the first six months of employment.

- **Practical Note:** One way a client employer might deal with the need to hire short-term full-time employees (for example, to temporarily replace regular employees who are on leave, or to fill in for various regular employees who will be out on vacation during the summer) is to hire them through a temporary staffing firm. This means the client employer will not be the common law employer and will not have to offer coverage after three months/90 days or face potential penalties. But it also means that the temporary staffing firm will be the common law employer and will have to determine whether the new employee is “reasonably expected” at date of hire to work on average at least 30 hours per week (whether for this client employer or for several different ones). That is why the final regulations enumerate factors an employer can use to determine whether a new hire is a full-time employee or a variable hour employee.

**Special Rule re: Home Care Workers Hired through Staffing Agencies**

The final regulations include a special rule for home care workers. Often a home care worker is hired through a staffing agency (either for a short-term or an indefinite period of time) and paid by the home care staffing agency, but under the “common law” test the workers would be classified as the employee of the service recipient. (This is because the service recipient sometimes will select the individual who will provide the care, and usually will set the hours of work and the tasks to be performed.) The special rule allows a home care worker to be considered the employee of the service recipient, rather than the agency. Since the service recipient probably employs only one (possibly two) home care workers, the recipient would not be a large employer and the home care worker would not be entitled to health insurance.

**Small Employers Who are Not Subject to the Employer Mandate**

What about small employers, who are not subject to the ACA employer mandate? (This will be employers with fewer than 100 full-time employees and full-time equivalents in 2015, and fewer than 50 after 2015.) They probably will not want to hire temporary workers through staffing firms that provide benefits, particularly if the small employer does not provide benefits for some or many of its regular employees. Some of these employers may want to hire temporary workers only through small staffing agencies, who also are not subject to the employer mandate.

For additional detail on types of staffing firms and the common law employment test, see “The Common Law Employer Test and the ACA – Will Businesses Be Responsible for Temporary Employees Assigned by Staffing Firms?” by Alden Bianchi & Edward Lenz, in Bloomberg BNA Tax Management Memorandum, 2/24/2014.