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THE AFFORDABLE CARE ACT'S "PLAY OR PAY" DECISION: HOW DO YOU HANDLE CONTINGENT WORKERS HIRED THROUGH A STAFFING AGENCY?

Companies that use third parties to handle some or all of their staffing needs have special considerations in determining how to address the new Affordable Care Act's "play or pay" regime that requires employers to offer health coverage to full-time employees or risk paying a tax penalty. Although the government has delayed the effective date for the new employer penalty, if a company uses a staffing agency, leasing company, professional employer organization (PEO), or other third party to secure workers, these concerns may result in questions for the company as early as this fall when workers begin exploring coverage through the new state insurance marketplaces. These concerns apply to all "contingent workers," including temporary workers, long-term regular workers, and rehired retirees.

"PLAY OR PAY"

Beginning in 2015 (following the one-year delay of implementation that the federal government announced on July 2), "large employers" will risk paying a tax penalty if they do not offer health coverage to their full-time employees and those employees' children. This "play or pay" regime is briefly summarized below and discussed in more detail in the *Jones Day Commentary* "Deciding Whether to Play or Pay Under the Affordable Care Act." Under "play or pay," an employer can be subject to one of two penalties: the no coverage penalty and the insufficient coverage penalty.

The no coverage penalty applies if an employer does not offer health coverage to "substantially all" of its full-time employees and their children and any one of the employer's full-time employees receives a premium tax credit to buy coverage through a state insurance marketplace. "Substantially all" is generally defined as at least 95 percent. The penalty can be significant for an employer that does not offer coverage, as it generally applies at the rate of $2,000 per full-time employee for the year. The first

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30 employees are not included in the penalty calculation. For example, if an employer had 1,000 full-time employees in each month of the year and did not offer them health coverage or offered health coverage to fewer than 950 of them, the employer would owe a penalty of $1,940,000 for the year ($2,000 x 970 full-time employees).

The insufficient coverage penalty applies if an employer offers coverage to "substantially all" full-time employees and their children and one or more of the employer's full-time employees receives a premium tax credit to buy coverage through a state insurance marketplace. The insufficient coverage penalty applies at the rate of $3,000 for the year, but only for those full-time employees who were able to receive a premium tax credit because that employee's coverage was not affordable or did not provide minimum value or because that full-time employee was not one of the "substantially all" who were offered coverage.

DEFINITION OF "EMPLOYEE"

Because "play or pay" penalties can be incurred if an employer does not offer coverage to its full-time employees, it is important for an employer to identify who its employees are for these purposes. The statute is silent in this regard. However, the proposed regulations implementing the penalty provide that the term "employee" means a common law employee.[1] Generally speaking, an individual who provides services to an employer is a common law employee if the employer has the authority to direct and control the manner in which services will be performed. An employer need not actually direct and control the work; the mere right to do so creates the employment relationship. Moreover, state laws, such as laws that establish the employer/employee relationship when a professional employer organization provides workers to a service recipient company, do not control who is the common law employer for purposes of "play or pay."

In determining which workers are common law employees, the IRS has taken the position that "[a] correct determination can only be made by examining the relationship of the worker and the business."[2] The IRS looks to three aspects of the relationship in making this determination: behavioral control, financial control, and the relationship of the parties.

Behavioral Control. A company has behavioral control over a worker when it has authority over where to do the work, what tools or equipment to use, what work must be performed by a specified individual, what routines are to be used, and what order or sequence is to be followed. The determination of whether a company has behavioral control also depends on the degree of instruction, the extent to which the company retains the right to control the worker's compliance with the instructions, and the effect on the worker in the event of noncompliance. Generally, the more detailed the instructions are for the worker, and the more control the company exercises over the worker, the more likely it is that the company retains the right to control the methods by which the worker performs the work.

Financial Control. Whether a company has financial control over the relationship with the worker, i.e., the economic aspects of the relationship, depends upon whether the worker makes a significant financial investment in performing the work, the extent to which the worker incurs expenses that the company does not reimburse, the extent to which the worker makes his or her services available on the open market, and the worker's opportunity for profit or loss. The IRS has taken the position that the ability to realize a profit or incur a loss is the strongest evidence that the worker controls the business aspects of services rendered. But this, by no means, is the only relevant factor.

Relationship of the Parties. This factor reflects how the worker and the company perceive their relationship to each other. The relationship of the parties is important because it reflects the parties' intent concerning control of work. Intent can often be found in the written contract, although a contractual designation, in and of itself, is not sufficient evidence for determining whether a worker is an employee. Similarly, providing a worker with employee benefits has traditionally been associated with employee status. Courts have also considered the existence of an ongoing relationship between the worker and the company as relevant in determining whether there is an employer-employee relationship. Therefore, if a company engages a worker with the expectation that the relationship will continue indefinitely, rather than for the duration of a specific project or period, the indefinite duration is evidence of an intent to create an employment relationship. The IRS takes the position that a

relationship that is long-term, but not indefinite, is a neutral factor in determining employee status.

It is entirely possible, and in fact likely in some circumstances, that a company that uses a third party for some of its staffing needs is actually the common law employer of these workers, even though the third party handles payroll and benefits, and may have initially hired the worker.[3] Furthermore, it is extremely rare for a joint or co-employment relationship to exist under the IRS's common law test. Under these rules, contingent workers of all types, including temporary workers, long-term regular workers, and retired employees who have been rehired, can all potentially be common law employees of the company that is receiving their services and not of the third party that hired them and sent them to the worksite.

For 35 years, companies facing potential worker reclassification by the IRS have been able to rely on section 530 of the Revenue Act of 1978 ("section 530") to protect them from significant prior tax liabilities. A company can invoke relief under section 530 when it did not treat a person as an employee for any period, it filed all federal tax returns (including information returns) it was required to file with respect to that person, and had some reasonable basis for the non-employee treatment. A company gets this relief even if the IRS would otherwise conclude that the workers are common law employees. By its terms, section 530 provides relief only with respect to employment taxes. The IRS has not yet indicated whether it would still pursue a "play or pay" penalty against a company based on the consequences of reclassifying workers where the company was otherwise protected by section 530.

CONSIDERATIONS FOR "PLAY OR PAY" COMPLIANCE

In light of the definition of "employee" set forth in the proposed regulations for the employer "play or pay" requirement, the treatment of contingent workers will merit special attention. Some issues to consider are:

How Are the Contingent Workers Likely To Be Classified? In determining who is the employer for purposes of "play or pay," you would look to the same behavioral control, financial control, and relationship of the parties factors that the IRS will use to assess which contingent workers would likely be classified as common law employees of the client company versus the third party. Any workers who are likely to be classified as common law employees need to be included when determining whether the employer is offering health coverage to at least 95 percent of its full-time employees. Making this assessment of potential common law employee status is particularly important where contingent workers are more than 5 percent of an employer's full-time work force, because failure to offer them coverage could result in the substantial no coverage penalty even if all the workers otherwise recognized as common law full-time employees are offered coverage.

Terms of the Contingent Worker Agreement. The service recipient and the third party will want to consider the "play or pay" requirement in negotiating the terms of the contingent worker agreement, both to minimize potential exposure and to assign clear responsibility for obligations the employer must meet. Simply stating in the agreement that the third party is the employer of the workers it is supplying will not be sufficient to make the third party the "employer." Similarly, stating in the agreement that the service recipient is the employer for purposes of the employer "play or pay" requirement will not make the service recipient the employer. Whoever has the right to direct and control the workers is the employer.

It is common for the agreement to make the third party responsible for paying the workers, paying their employment taxes, and providing any benefits that may be made available. The parties may wish to have the third party offer affordable, minimum value health coverage to the workers it is supplying. If the third party is the common law employer, doing so will protect the third party from the penalty. If, instead, the client company is the common law employer, having the third party offer this coverage may reduce the risk of the client company incurring a penalty. Although it is not clear under current guidance that coverage offered by a third party—and not by the employer itself—meets the technical requirements of "play or pay," ensuring that the workers are offered affordable, minimum value coverage can mitigate exposure. First, workers who take the affordable,

minimum value coverage will not receive premium tax credits and cannot, by themselves, trigger a "play or pay" penalty. Second, although the proposed regulations do not give the employer credit for offering coverage when it contracts with a third party, the contractual agreement still achieves the policy goal of ensuring that employers provide access to affordable coverage. Given the difficulties in knowing exactly how the IRS will classify workers, a contractual provision of this type will at least give the employer an argument for contesting a penalty and may decrease the IRS's interest in pursuing strict enforcement. Furthermore, as the IRS reviews comments on its proposed regulations, it may make changes to take account of these third party arrangements.

Full-Time Employee Reporting Requirement. Beginning in January 2015 (again following the one-year delay announced by the federal government), large employers will be required to report to the IRS regarding who their full-time employees were in the prior calendar year and whether they were offered affordable, minimum value coverage. The first reports will be due in January of 2016. Consideration should be given regarding how to handle workers acquired through a third party who work enough hours to be considered full-time. Will the client company report these workers as their full-time employees, or will the third party vendor handle the reporting? How will the questions regarding the offer of coverage be answered, particularly if the coverage is offered through the third party, but the common law employer is the client? Because this filing will be a tax filing made under penalties of perjury, it is important that the agreement between the company and the third party reflect a clear understanding of the employment relationship and the associated reporting requirement. Consideration should also be given to reconciling between who is the common law employer for purposes of full-time employee reporting and who is the employer for purposes of ERISA requirements, such as reporting on the Form 5500.

Providing Information to Workers Required under the FLSA and Needed for Premium Tax Credit Eligibility. The Affordable Care Act added a new section to the Fair Labor Standards Act that requires every employer subject to the FLSA to provide their employees with a notice informing them about the new state insurance marketplaces and providing certain information about any health coverage the employer may offer. This FLSA notice requirement is discussed in more detail in the *Jones Day Commentary* "New Affordable Care Act Notice to Employees Must Be Provided by October 1, 2013." Contingent workers who wish to explore their eligibility for financial assistance through one of the new state insurance marketplaces will need to complete an application that asks for information about any health coverage they are offered by their employer. The FLSA notice can be used as a vehicle for providing that information, at the employer's election. To ensure that the required FLSA notice is provided on a timely basis, the company and the third party should agree to the contents of a notice and specify who will provide the notice, both for purposes of the initial distribution later this year and the ongoing distribution required for workers hired after September 30 of this year. In the absence of clear guidance on who will be considered the employer, this approach should be a practical way to address the legal requirement. Regardless of who is considered the employer for purposes of the "play or pay" requirement, the guidance to date on the FLSA notice appears to leave room for the notice to be provided, directly or through an agent.

Rehired Retirees. Occasionally, a company's retirees are rehired through a third party process. If the retiree becomes a common law employee of the client company and is offered coverage through a retiree plan, the employer will be given credit for making an offer of coverage for purposes of "play or pay." There is no requirement that employees be offered coverage in the active employee plan. However, if the retiree plan is exempt from certain coverage mandates on the basis that it is a retiree-only plan (e.g., covering preventive care with no cost sharing, prohibition on annual and lifetime dollar limits), and the retiree rehired through the third party is actually the common law employee of the client, offering coverage to this retiree through the retiree health plan may destroy the "retiree-only plan" status. Without the "retiree-only plan" status, the retiree plan must comply with the coverage mandates. Thus, special care must be taken if there is a possibility that a third party will hire a company's retirees and assign them to do work at the company. Doing so could force the company to make changes to its retiree health plan.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Elena Kaplan
Atlanta
+1.404.581.8653
ekaplan@jonesday.com

Brent D. Knight
Chicago
+1.312.269.4290
bdknight@jonesday.com

Catherine E. Livingston
Washington
+1.202.879.3756
clivingston@jonesday.com

Terri L. Chase
New York
+1.212.326.8386
tlchase@jonesday.com

Kirstin Poirier-Whitley
California Region
+1.213.243.2380
kpoirierwhitley@jonesday.com

Rick Bergstrom
California Region
+1.858.314.1118
rjbergstrom@jonesday.com

Lawrence C. DiNardo
Chicago
+1.312.269.4306
lcdinardo@jonesday.com

F. Curt Kirschner, Jr.
California Region
+1.415.875.5769
ckirschner@jonesday.com

Michael J. Gray
Chicago
+1.312.269.4096
mjgray@jonesday.com

ENDNOTES

1 Under the proposed regulations, a leased employee, a sole proprietor, a partner in a partnership, or a 2-percent S corporation shareholder is not considered an employee. Prop. Reg. § 54.4980H-1(a)(13).

2 *See* Department of the Treasury Internal Revenue Service, "Independent Contractor Or Employee?: Training Materials," at p. 2-5, *available at* http://www.irs.gov/pub/irs-utl/emporind.pdf (last accessed July 17, 2013).

3 Although the proposed regulations do include a special rule regarding leased employees, it provides that even if the leased employee must be treated as an employee of the service recipient for purposes of qualified retirement plans, this treatment has no bearing on whether or not the worker is a common law employee for purposes of "play or pay."

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