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INTELLIGENCE REPORT

Assignment Limits and Concerns About Benefits Liability

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The Issue

Human resource professionals at organizations that use staffing services have concerns about benefits liability, stemming largely from litigation during the 1990s involving Microsoft Corp. *(Vizcaino v. Microsoft)*. In the late 1980s, Microsoft used independent contractors to do the same kind of work done by its direct employees. After the Internal Revenue Service ordered the contractors to be reclassified as employees, Microsoft hired many of them directly or engaged them through staffing firms.

The former contractors later sued Microsoft, claiming to be common-law employees of Microsoft and entitled to the company's benefits—retroactively. After years of litigation, the court concluded that the former contractors were common-law employees of Microsoft and entitled to the company's stock purchase benefits. Microsoft settled the case in 2000 for $97 million.

In the wake of the Microsoft litigation, some companies adopted policies that limited the length of assignments for temporary and contract employees from staffing firms. Companies saw this as a way to protect themselves from the kind of "retro-benefits" claims faced by Microsoft. Some of these policies appear to be based on the erroneous belief that, after working for a certain period of time, temporary or contract employees are automatically eligible for coverage under a client company's benefit plan, or even entitled to be hired for a regular full-time position with the company.

Because assignment limits can cause economic harm to temporary or contract employees whose assignments are terminated prematurely, and can disrupt a company's business operations, HR professionals should look closely at their organization's staffing policies to ensure that such limits are truly necessary and not based on misinformation. To help dispel some of the common legal misperceptions, this paper discusses the basic principles of law that apply to employee benefit plans, then decribes steps client companies can take to avoid retro-benefits exposure.

Erisa

The principal law regulating employee benefits is the federal Employee Retirement Income Security Act, which sets rules for the structure and administration of employer retirement and other benefit plans. It does not, however, require employers to offer benefits or dictate what level of benefits must be provided.

Although benefit plans are generally regulated by Erisa, federal tax law also comes into play. While the tax rules do not require employers to offer benefits, they encourage employers to do so by allowing certain benefit costs under a "tax-qualified" plan to be deducted by employers and to be excluded from income by employees.

Some of these tax advantages are conditioned upon the plan satisfying certain coverage and nondiscrimination rules. For example, retirement plans, including pension, profit-sharing, and 401(k) plans, cannot discriminate in favor of highly paid employees either in their coverage or their level of benefits. So-called "welfare" plans, such as life and health insurance, generally either are not subject to such rules, or are subject to somewhat more liberal coverage and nondiscrimination rules.

Companies generally do not have to cover all employees to have a tax-qualified plan. For example, under a pension, profit-sharing, or 401(k) plan, a company generally can exclude up to 30% of its rank-and-file employees without endangering the plan's tax-advantaged status. As explained later, this "slack" is why companies can usually exclude staffing firm employees from their benefit plans without jeopardizing the tax status of those plans.[1]

Common Misconceptions Regarding Erisa and Tax Code 'Hours' Rules

Some companies, relying on the Erisa "year of service" rule, terminate staffing firm employees before they reach 1,000 hours in the belief that all individuals who work at least 1,000 hours in a year are entitled to participate in a company's retirement plan. But the rule does not apply to staffing firm employees or to employees who have been expressly excluded from the plan under a proper exclusion provision. As discussed later, companies can take steps to avoid having staffing firm employees classified as their employees and can lawfully exclude them from their benefit plans regardless of their length of assignment.[2]

Other assignment-limit policies are based on the federal tax code provisions dealing with "leased employees"—Internal Revenue Service code section 414(n). Leased employees are individuals who are not common-law employees of a company but who have worked under the company's direction on a substantially full-time basis (generally 1,500 hours) for at least one year.

The section 414(n) rules do not require companies to provide benefits to leased employees—in fact, leased employees can and should be excluded from a company's benefit plan. The rules only require that leased employees be included in the company's head count for discrimination testing. This is not a problem unless the company has so many leased employees (and other excluded employees) that they exceed the "slack" in the company's plan, which could affect the plan's tax qualification. Staffing firms can help manage this for their clients by keeping track of the number of leased employees to ensure that the slack is not exceeded.

Companies can also protect against retro-benefits liability in a number of ways discussed later. Companies and their staffing firms should always consult with legal counsel on how best to implement these strategies, especially those involving plan amendments and employee waivers.

Plans Should Expressly Exclude Staffing Firm Employees

The most important step companies can take to protect themselves is to amend their benefit plans to clearly exclude staffing firm employees. The courts and the IRS expressly allow this. Further information is available in the IRS Technical Advice Memorandum, which is posted on the ASA Web site, *americanstaffing.net* (in the left navigation bar, click on Legal & Government Affairs, then Issue Papers).[3]

Keeping in mind that any plan language should be discussed with legal counsel, the following template language is suggested for the purpose of excluding staffing firm employees from participation in a company's Erisa plan:

> The Plan includes any employee of [Company] who is paid in U.S. currency, but shall not include
>
> 1. An individual whose services are used by [Company] pursuant to an employment agreement or personal services agreement if such agreement provides that such individual shall not be eligible to participate in [Company] Plan.
>
> 2. Individuals who are not paid directly by [Company] or an affiliate of [Company].
>
> 3. Individuals who are not on [Company's] payroll.
>
> 4. Individuals who are "leased employees" within the meaning of 414(n) or (o) of the Internal Revenue Code.
>
> 5. Individuals whom [Company] does not treat as its employees for federal income tax withholding or employment tax purposes.

Employee Waivers

In addition to amending their benefits plans to expressly exclude staffing firm employees, companies may be able to achieve additional protection through agreements in which the staffing firm's employees expressly waive their right to the company's benefits. Court decisions generally support such agreements, but the agreements must be written carefully. Some benefits experts believe such agreements are not enforceable unless they are consistent with, and expressly sanctioned by, the company's benefit plan, which suggests that the agreements must be tailored to each company's situation. This should be discussed with legal counsel.

Amending benefit plans to exclude staffing firm employees and executing employee waivers are important steps companies should take to protect themselves against retro-benefits liability. But there is another step they should take. Because only employees may be considered eligible for benefits, companies should minimize their contacts with staffing firm employees to avoid having them classified as the company's employees in the first place.

For example, staffing firms should take responsibility for

- Recruiting, screening, testing, training, and interviewing the employees
- Determining the employees' wages, benefits, and expense reimbursement
- Hiring, firing, assigning, and reassigning the employees
- Handling the employees' complaints and discipline
- Distributing the employees' paychecks

Other steps that can be taken include

- Requiring distinctive badges for employees supplied by staffing firms
- Making separate reference to the staffing firm employees in company communications
- Channeling any social invitations through the staffing firm
- Making appropriate distinctions between staffing firm employees and regular employees in business cards, letterheads, etc.
- Maintaining a staffing firm presence at the work site

Length of assignment is not the sole issue in determining the employment status of employees supplied by staffing firms. For tax and benefits purposes, it is one of many factors under the common-law control test. Assignment limits may even carry some risk if the company has not clearly excluded staffing firm employees from its plan, as previously discussed, because they might be construed as an effort to deny benefits by preventing staffing firm employees from reaching the hours needed for plan participation. Companies could face charges of violating Erisa, which protects employees from such employer action.

An example of how companies can avoid common-law employer status by minimizing their contacts with staffing firm employees can be found in an unpublished opinion by a California federal district court in the same jurisdiction that decided the *Microsoft* case, *Burrey v. Pacific Gas and Electric Co*. The *Burrey* case involved former employees of PG&E who were transferred to staffing firms and continued to work at PG&E for 10 years. Despite the length of the employees' assignments, the court found insufficient evidence to establish common-law employment and ruled that the workers were not entitled to PG&E's benefits. A copy of the opinion is available from ASA.

HR professionals are encouraged to review their companies' assignment-limit policies to determine whether they are too restrictive or even unnecessary. In any case, companies should amend their benefit plans to exclude staffing firm employees and minimize their contacts with them as outlined in this paper. Taking these steps will reduce companies' exposure to retro-benefits liability.

1. Certain stock purchase plans, such as those involved in the *Microsoft* case, don't allow such slack because the tax rules applicable to those plans require virtually all employees to be covered. As a result, many employers that provide stock option benefits use nonqualified plans or "incentive stock options," which are not subject to the coverage rules.

2. It's also worth noting that a 1,000-hour limit won't protect companies from liability under benefit plans such as health insurance that typically provide coverage within much shorter time frames.

3. Companies will need to be careful in how this exclusion is framed. Exclusions may run afoul of the IRS and Erisa minimum service requirements if they are viewed as "service-related" (e.g., exclusions for "part-time," "seasonal," or "temporary" employees) as opposed to exclusions that are job-related (e.g., exclusions for substitute workers or workers who are not on the employer's payroll). (See Feb. 14, 2006, IRS Quality Assurance Bulletin, posted on the ASA Web site, americanstaffing.net. In the left navigation bar, click on Legal & Government Affairs, then Issue Papers. The bulletin is posted under the heading "Assignment Limits and Client Concerns About Benefits Liability: Issues and Answers.")

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