retained by firms and who provide technical services will be classified for income and employment tax purposes as employees or independent contractors under the common-law test without regard to the safe harbor provisions of section 530.

c. *IRS Classification Guidelines*

At the same time that Congress enacted the section 530 changes, the IRS issued new guidelines to its audit staff on the issue of employee classification. In a memo dated July 15, 1996, IRS commissioner Margaret Miner Richardson pledged that in the future training of auditors, the IRS would "assure that both businesses and workers, whether under the withholding rules or under the rules governing the self-employed, pay the proper amount of taxes." In other words, there should be no bias in favor of either employee or independent contractor status. Rather, she wrote, "The examiner has a responsibility to the taxpayer and to the government to determine the correct tax liability and to maintain a fair and impartial attitude in all matters relating to the examination."

Although legislation has been introduced in recent years to modify the criteria used to classify employees for employment tax purposes, the IRS audit training manual continues to rely on the traditional common-law standard, which focuses on the right to direct and control the worker. However, the agency's guidelines make clear that the 20 factors are not the only relevant factors. According to the guidelines, "Every piece of information that helps determine the extent to which the business retains the right to control the worker is important." The guidelines distill the 20 factors into three major evidentiary categories, including behavioral control, financial control, and the relationship of the parties.

4. Wage and Hour Issues

The federal Fair Labor Standards Act establishes minimum wage, overtime, equal pay, payroll record-keeping, and child labor requirements for most employers. The FLSA applies to any business on which an employee is dependent as a matter of "economic reality."

The courts have established a five-part economic reality test for determining the existence of an employment relationship under the FLSA. The five parts are (1) the degree of control exercised by the service recipient over the employee, (2) the employee's opportunities for profit or loss and his or her investment in the business, (3) the degree of skill and independent initiative required to perform the work, (4) the permanence or duration of the working relationship, and (5) the extent to which the work is an integral part of the employer's business.[30]

30. Brock, *supra* note 32, at 1058-59.

In addition, DOL regulations expressly impose joint employment obligations in specified circumstances. For example, if an employee is employed jointly by two or more employers during a workweek, all of the employee's work during the week is considered one employment, and all employers are responsible for compliance with the wage and hour provisions for the period worked for each employer.[31]

In a 1968 opinion letter, DOL applied these regulations in a case involving temporary staffing (see Appendix E). DOL made two key points. First, temporary staffing companies, not their clients, have primary responsibility for keeping records of hours worked and for paying the proper amount of overtime. At the same time, the DOL asserted that temporary employees assigned to work for various clients are typically employed jointly by the temporary staffing company and its clients, and clients may be held jointly responsible for overtime and minimum wage obligations.

More recently, and pursuant to the DOL's fissured industries initiative,[32] the DOL's Wage and Hour Division (WHD) has pursued the joint employment and liability theory against temporary staffing firms and their clients.[33] Between 2009 and 2013, WHD conducted approximately 1,000 investigations of temporary staffing firms.[34] After one such investigation, a client settled with WHD for nearly $500,000 in back wages and liquidated damages after WHD determined that the client jointly employed the temporary workers who worked at its storage and packing facility, and the client was jointly liable for failure to pay the temporary workers for all hours worked.[35]

In the case of overtime, a client is jointly liable with the temporary staffing firm for the payment of overtime only if the temporary employee worked more than 40 hours in the week for that client.[36] If the staffing firm exercises no control over the employees (i.e., has no right to hire or fire, set pay, or determine assignments) and is simply a payroll agent, the client may be considered the employer for FLSA purposes.[37] Moreover, if a temporary employee is placed with a client

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31. 29 C.F.R. § 791.2.

32. See U.S. Department of Labor Strategic Plan, Fiscal Years 2011-2016, at *dol.gov/_sec/stratplan/StrategicPlan.pdf*; U.S. Department of Labor Strategic Plan, Fiscal Years 2014-2018, at *dol.gov/_sec/stratplan/FY2014-2018StrategicPlan.pdf.*

33. See May 15, 2013 Press Release of the United States Department of Labor Wage and Hour Division, Release No. 13-662-NEW (wh 13-043), at *dol.gov/whd/media/press/whdpressVB3.asp?pressdoc=Northeast/20130515.xml.*

34. See *id.*

35. See *id.*

36. Department of Labor Opinion Letter No. 874, Oct. 1, 1968. *See, e.g.,* Barfield v. New York City Health & Hosp. Corp., 432 F. Supp. 2d 390 (S.D.N.Y. 2006). Of course, temporary employees are not always jointly employed by the client. *Pfohl v. Farmers Ins. Group*, No. CV03-3080 DT (RCX), 2004 WL 554834, at *4-7 (C.D. Cal. 2004) (court held that an insurance company exercised no control over the job activities of a worker assigned by a staffing firm as a claims adjuster and therefore had no obligation to pay overtime to the worker).

37. Catani v. Chiodi, No. CIV. 00-1559 (DWF/RLE), 2001 WL 920025 (D. Minn. Aug. 13, 2001) (the staffing firm had no authority to fire, schedule, or give raises to the workers, nor did it train, supervise, or discipline them).

by several staffing firms and works over 40 hours in a week for the client but not more than 40 hours for any one of the staffing firms, the client may be *solely* liable for overtime.[38]

Apart from federal law, California law imposes joint liability on clients of labor contractors for failure to pay proper wages and maintain valid workers' compensation insurance. The term "labor contractor" is defined as any entity that supplies workers to perform labor within a client's usual course of business, including staffing firms. California clients historically have been treated as joint employers with staffing firms for wage and hour and other employment law purposes, and this law codifies the joint employment principle. The law also requires claimants to provide clients with 30 days' notice prior to filing a lawsuit. This requirement will give clients the opportunity to refer matters to staffing firms for resolution before litigation.

In some circumstances, staffing firm clients may be exempt from overtime requirements given the nature of their business. In addition to the so-called white-collar professional, executive, and administrative exemptions, the FLSA also contains other, less familiar, exemptions that focus on the nature of the establishments that employ the employees. These exemptions may apply to staffing firms when they place temporary and contract employees with clients that qualify for the exemptions.

For example, in *Tidd v. Adecco*, a Massachusetts federal court held that temporary employees were jointly employed by FedEx and the staffing firms that assigned them, and thus the staffing firms shared FedEx's exemption from all overtime pay requirements under the federal Motor Carrier Act.[39]

The court found that if the Motor Carrier Act did not apply to jointly employed workers, the law's purpose would be frustrated because such workers would not be subject to the safety requirements of the law and the U.S. Department of Transportation. Conversely, the court noted, extending the Motor Carrier Act overtime exemption to joint employers prevented circumvention of DOT's authority. As a result, the court held that the staffing firms were exempt from paying the assigned employees overtime.

5. Health and Pension Benefits

The primary co-employment concern in the benefits area is whether a staffing firm client has a legal obligation to provide benefits to a staffing firm's employee. The answer is generally no, but this area of law is highly fact specific.

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38. Barfield v. New York City Health & Hosp. Corp., 537 F.3d 132 (2d Cir. 2008).

39. *See* Tidd v. Adecco USA Inc., No. 07-11214-GAO, 2010 WL 996769, at *2-3 (D. Mass. Mar. 16, 2010).

(A quick-reference guide to the most frequently asked questions in this area is included in Appendix F.)

Laws in San Francisco and the federal Patient Protection and Affordable Care Act require employers to either provide health insurance coverage or pay a tax penalty to the government, but no law (except one in Hawaii, which requires employers to provide health coverage to full-time employees) requires employers to provide health or pension benefits to their employees or to anyone else's employees. But federal tax law does require employers to include "leased employees" in their head counts for the purpose of the coverage tests applicable to certain employer benefits plans.

To understand how the leased employee rules work, it is essential to understand the tax policy behind the so-called "coverage tests."

a. Coverage Tests

Federal tax law does not require employers to provide their employees with benefits such as pensions and health insurance. However, it does provide incentives designed to encourage employers to offer benefits to certain rank-and-file employees. For example, businesses may deduct the cost of the benefits, which generally are not included as taxable income to employees. To qualify for favorable tax treatment, however, plans must cover employees fairly (i.e., they cannot discriminate in favor of higher-paid employees).[40]

To ensure that employer-provided retirement plans do not discriminate in favor of higher-paid employees, the law establishes coverage tests that require plans to cover a minimum percentage of lower-paid employees.[41] To determine if they pass the tests, employers have to count their employees and make a number of calculations. Plans that pass the tests and meet other requirements qualify for the tax benefits described in the previous paragraph (hence the term "qualified" plan). Because substantial adverse tax consequences can result if a plan fails the coverage tests, staffing firms and their clients should seek professional tax advice concerning the specific application of the tests to their benefit plans.

Beginning with plan years after Dec. 31, 1988, the 1986 Tax Reform Act imposed much stricter coverage tests for retirement plans. Under the act's amendments, one of two tests must be passed: A plan must cover (1) a percentage of rank-and-file employees equal to at least 70% of the percentage of higher-paid employees benefited, or (2) a nondiscriminatory classification of employees based

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40. Note that in the case of stock purchase plans (section 423 plans) such as those involved in the Microsoft lawsuit (*see* discussion beginning on p. TK, *infra*), employers may not be able to exclude individuals deemed to be their common-law employees. This is because the IRS rules applicable to those plans require virtually all employees to be covered. As a result, many employers that provide such benefits use *nonqualified* stock purchase plans, which are not subject to nondiscrimination rules.

41. I.R.C. § 410(b).

on objective standards and provide lower-paid employees an average benefit that is at least 70% of the average benefit provided to higher-paid employees.

Since the new coverage tests became effective, employers can no longer provide qualified retirement benefits simply by covering a nondiscriminatory classification of employees (e.g., full-time salaried employees). Staffing firms, for example, must apply more stringent tests that require counting their temporary employees. This makes it virtually impossible for them to maintain their plans' tax-qualified status because the relatively large numbers of temporary employees excluded from the plans practically guarantee that the plans will fail the tests. Consequently, many staffing firms were forced to terminate their qualified retirement plans as a result of the new coverage tests.

The new coverage tests apply to retirement plans but not to other kinds of benefit plans such as self-insured group health plans and group life insurance. Those plans remain subject to pre-1986 coverage tests, which permit employers to provide benefits to nondiscriminatory classifications of workers (e.g., home office staff or employees assigned to particular clients). It is not entirely clear, though, to what extent the determination of what is a nondiscriminatory classification is affected by the new objective standards applicable to retirement plans.

Insured health plans historically were not subject to any nondiscrimination coverage tests, either pre-1986 or post-1986.[42] However, the Patient Protection and Affordable Care Act enacted in 2010 provides that, effective Jan. 1, 2011, all insured group health plans are subject to nondiscrimination rules similar to the rules applicable to self-insured health plans.[43]

Leased Employee Rules

As noted above, the tax code requires employers to satisfy applicable coverage tests by taking into account workers who are their common-law employees. When applying the tests, the tax code also requires employers to include in their head count certain employees, *who are not their common-law employees,* supplied by third-party contractors. These rules, sometimes referred to as the "leased employee rules," are set forth in section 414(n) of the Internal Revenue Code, which applies to tax years after Dec. 31, 1983.[44]

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42. It should be noted that staffing firms generally cannot include in their plans workers who are not their common-law employees.

43. Patient Protection and Affordable Care Act, Pub. L. No. 111–148, § 1001, 124 Stat. 119 (March 23, 2010). As this edition went to press, however, enforcement of the discrimination testing requirement had been suspended pending the issuance of regulations.

44. The concept of joint employment generally is not recognized in the area of employee benefits. Courts therefore resolve benefits liability issues in terms of the single employer who is the common-law employer. Section 414(n) assumes that leased employees are the common-law employee of the leasing organization because, by its terms, the section does not apply to employees who are common-law employees of the recipient (client). *See* I.R.C. § 414(n).

Section 414(n) was enacted to address the practices of certain small professional groups that fired their entire staffs, transferred them to the payroll of leasing organizations, and then set up rich pension plans for themselves, thus circumventing the coverage tests. Section 414(n) dealt with this practice by requiring employers to treat certain outside employees as leased employees who must be counted along with their own employees when applying the coverage tests. (For the full text of section 414(n), see Appendix F.) As the following definition indicates, section 414(n) is very broad. Employees supplied by many traditional service providers, including long-term employees supplied by staffing firms, may have to be counted as leased employees, even though clients do not use them to replace full-time employees or to circumvent the coverage tests.

Definition of Leased Employee

Section 414(n) defines a leased employee as any person furnishing services to a recipient if the following conditions are met:

- The person must perform services under an agreement between the recipient employer and the leasing organization.
- The person must perform services under the primary direction and control of the recipient.
- The person must perform services on a substantially full-time basis for a one-year period. Under IRS guidance, this test is met if one of the following conditions is met during a consecutive 12-month period: The employee performs at least 1,500 hours of service for the client (or related entities), or the employee performs a number of hours of service for the client (or related entities) that is equal to at least 75% of the average number of hours customarily worked by the client's own employees performing similar services.

The "substantially full-time" test under section 414(n) is different from the "year of service" test under the Employee Retirement Income Security Act, which uses a 1,000-hour standard for participation, benefit accrual, and vesting. ERISA and section 414(n) have different purposes and requirements. ERISA sets forth rules for an employer's benefit plans, but they apply only to the employer's own employees. Section 414(n) applies to an employer's use of outside employees.

b. Control Test

The "primary direction and control test" of section 414(n), enacted as part of the Small Business Job Protection Act of 1996, replaced a test under prior law that looked to whether services performed by employees for a recipient were of a type historically performed by employees in the recipient's field of business. This test was widely criticized as being too broad in its application. The control test significantly narrows the scope of the leased employee rules.

Effective Jan. 1, 1997, clients do not have to count third-party employees as potential leased employees when their work is directed and controlled primarily by a staffing firm and not the client. Whether an individual performs services under the primary direction or control of the client depends on the facts and circumstances. Relevant factors include whether the client has the right to direct where, when, and how the employee performs services; whether the client has the right to direct that services be performed by a specific person; whether the client supervises the worker; and whether the employee must perform services in an order set by the client.

The legislative history of the control test indicates that professionals (e.g., attorneys, accountants, actuaries, doctors, computer programmers, systems analysts, and engineers) are not considered leased employees if they regularly use their own judgment and discretion on matters of importance in the performance of their services and are guided by professional, legal, or industry standards. They do not have to be counted by the client, even though the staffing firm does not closely supervise them on a continuing basis and even though the client requires their services to be performed on site and in accordance with client-determined timetables and techniques.

The control test may benefit clients using professional services and managed services arrangements in which the actual day-to-day direction and control of employees at the work site is in the hands of the staffing firm. Office and clerical staffing services could also be exempt, but clients claiming exemption from the head-counting rules will have to satisfy a heavy burden of proof on the issue of control because the legislative history provides that clerical and similar support staff generally are considered to be subject to the client's primary direction or control and would be leased employees if the other requirements of section 414(n) are met.[45]

c. Benefit Plans Affected by the Leased Employee Rules—Application to the ACA

Section 414(n) leased employee rules come into play when applying coverage tests to retirement, life insurance, and cafeteria plans and when determining whether group health plans are subject to the Consolidated Omnibus Budget Reconciliation Act (COBRA) and certain Medicare coordination-of-benefit rules. But section 414(n) rules do not currently apply to the coverage tests relating to group health plans.

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45. *See* Small Business Job Protection Act of 1996, H.R. Rep. No. 104-737, Aug. 1, 1996, p. 260.

The Affordable Care Act addresses the treatment of leased employees in two specific contexts. First, the law expressly provides that leased employees must be included by any employer claiming a small business tax credit under the law.[46] This was to ensure that clients of professional employer organizations with less than 25 employees do not lose their ability to claim the small business tax credit provided by the ACA. But it also is intended to prevent larger employers from improperly claiming the credit by shifting employees to PEOs to lower their headcount. Second, the final regulations make clear that recipients do not have to count leased employees as employees for purposes of compliance with the employer shared responsibility rules.[47] Hence, staffing firm clients should have no obligation to include staffing firm employees for purposes of ACA compliance unless the client is determined to be the common law employer based on the facts and circumstances. Based on historical practice and legal precedent, staffing firms generally should be viewed as the common law employer, not the client.[48]

d. Record-Keeping Exemption

The Tax Reform Act directed the Treasury Department to issue regulations to minimize employer record-keeping under section 414(n).[49] According to the legislative history of this provision, Congress contemplated that employers do not have to maintain records of outside employees for coverage testing purposes unless the total number of such individuals performing 1,500 hours or more of service exceeds 5% of the employer's total lower-paid work force. To take advantage of this exemption, a client's benefit plans must not be top heavy under IRS rules and must specifically exclude leased employees.[50]

e. Safe Harbor Plans

Employees will not be treated as leased employees for pension plan purposes if they participate in a safe harbor pension plan provided by the leasing organization that meets the following conditions:

- The leasing organization must contribute at least 10% of the employee's compensation to the plan.
- The employee must be 100% vested in the contribution.

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46. Patient Protection and Affordable Care Act, §1421(e)(1)(B).

47. Treas. Reg. §54.4980H-1(a)(15); 79 Fed. Reg. 8579 (Feb. 12, 2014).

48. See Alden J. Bianchi and Edward A. Lenz, The Final Code §4980H Regulations; Common Law Employees; and Offers of Coverage by Unrelated Employers, BloombergBNA Tax Management Memorandum (Sep. 8, 2014).

49. *See* I.R.C. § 414(o).

50. For a full explanation of this exemption, *see* I.R.C. section 414(o) and the accompanying conference committee explanation at H.R. Rep. No. 99-841 (Vol. II, Sep. 18, 1986), pp. 496–497.