Assignment Limits and Client Concerns About Benefits Liability: Issues and Answers

The Issue

Staffing firm clients’ concerns about benefits liability largely stem 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 workers to be reclassified as employees, Microsoft hired many of them directly or engaged them through staffing firms.

The workers 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 they 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, clients increasingly began to adopt policies limiting the length of assignment of staffing firm employees as a way to protect against 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, such employees are automatically eligible for coverage under the client’s benefit plans, or even entitled to be hired into a regular full-time position with the client.

Because assignment limits can cause economic harm to staffing firm employees whose assignments are terminated prematurely and can disrupt clients’ business operations, ASA believes staffing firms should encourage clients to reexamine their policies to ensure that such limits are truly necessary and are 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 and then discusses the steps clients 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.
Tax Rules

Although benefit plans are generally regulated by Erisa, federal tax law also comes into play. While the tax rules also 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 (or receive other favorable tax treatment) by employees. Some of these tax advantages are conditioned upon the plan’s 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 (e.g., in the case of group-term life insurance plans).

Companies generally don’t 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 clients generally can exclude staffing firm employees from their benefit plans without jeopardizing their tax status.

Common Misconceptions Regarding Erisa and Tax Code ‘Hours’ Rules

Some clients, relying on the Erisa so-called “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 the client’s retirement plan. But the rule does not apply to nonemployees or to employees who have been expressly excluded from the plan under a proper exclusion provision. As discussed later, clients can take steps to reduce the likelihood of having staffing firm employees classified as their employees and can lawfully exclude them from their benefit plans regardless of their length of assignment.

Other client assignment limit policies are based on the federal tax code provisions dealing with “leased employees”—IRS Code section 414(n). Leased employees are individuals who are not common-law employees of a client but who have worked under the client’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 clients to provide benefits to leased employees—in fact, leased employees can and should be excluded from the client’s benefit plans. The rules only require in such case that leased employees be included in the client’s head count for discrimination testing purposes. This is not a problem unless the client has so many leased employees (and other excluded employees) that they exceed the “slack” in the client’s plan, which could affect the plan’s tax qualification. Staffing firms can help manage this for clients by keeping track of the number of leased employees to ensure that the slack is not exceeded.
How Clients Can Avoid Retro-Benefits Exposure

Clients can protect against retro-benefits liability in a number of ways as discussed below. Staffing firms and their clients should always consult with expert legal counsel on how to implement these strategies, especially those involving plan amendments and employee waivers.

Client Plans Should Expressly Exclude Staffing Firm Employees

The most important step clients should take 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 posted on the ASA Web site, americanstaffing.net. Keeping in mind that any plan language should be discussed with legal counsel, the following template language may be suggested to clients for the purpose of excluding staffing firm employees from participation in the client’s Erisa plan:

The Plan includes any employee of [Client] who is paid in U.S. currency, but shall not include

1. An individual whose services are used by [Client] pursuant to an employment agreement or personal services agreement if such agreement provides that such individual shall not be eligible to participate in [Client’s] Plan.
2. Individuals who are not paid directly by [Client] or an affiliate of [Client].
3. Individuals who are not on [Client’s] payroll.
4. Individuals who are “leased employees” within the meaning of §414(n) or 414(o) of the Internal Revenue Code.
5. Individuals whom [Client] does not treat as its employees for federal income tax withholding or employment tax purposes.

Employee Waivers

In addition to amending their benefit plans to expressly exclude staffing firm employees, clients may be able to achieve additional protection through agreements in which the staffing firm’s employees expressly waive their right to the client’s benefits prior to starting work with the client. Court decisions generally support such agreements, but the agreements must be carefully written and implemented. Some benefits experts believe such agreements are not enforceable unless they are consistent with, and expressly sanctioned by, the client’s benefit plan, which suggests that the agreements must be tailored to particular clients’ situations. This should be discussed with legal counsel.
To Avoid Employer Status, Clients Should Minimize Their Contacts With Staffing Firm Employees

Amending their benefit plans to exclude staffing firm employees and executing employee waivers are important steps clients should take to protect against retro-benefits liability. But there is another step they should take. Because only employees may be considered eligible for benefits, clients should minimize their contacts with the staffing firm employees to reduce the risk of their being classified as the client’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 client communications
- Channeling any client 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 supervisory 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 but one of many factors under the common-law control test. Assignment limits may even carry some risk if the client has not clearly excluded the staffing firm employees from its plan, as previously discussed, because they might be construed as an effort to deny benefits by preventing the staffing firm employees from reaching the hours needed for plan participation. Clients could face charges of violating Erisa, which protects employees from such employer action.

An example of how clients 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 the PG&E’s benefits. A copy of the opinion is available from ASA.
Summary

Clients should be encouraged to review their assignment limit policies to determine whether they are too restrictive or even unnecessary. In any case, clients 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 increase the value of staffing services to clients and reduce clients’ 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 clients from liability under benefits plans such as health insurance that typically provide coverage within much shorter time frames.

3 Clients 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 in effect “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.)