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Regulatory Update

Independent Contractors – Benefit Compliance Considerations

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Introduction

Employers enter into a variety of different staffing arrangements for things such as handling special projects, meeting varying capacity needs, and filling temporary employment gaps. When entering into such arrangements, it's important for employers to properly categorize such individuals as independent contractors or employees and then to ensure that benefits are handled accordingly. Determining employee status is critical for several purposes beyond that of handling benefits, but this issue brief focuses specifically on benefit considerations.

Status – Independent Contractor or Employee???

We warn employers to be careful because there is often misclassification in this area. Unfortunately, the ultimate distinction between "employee" and "independent contractor" is far from black-and-white. It would be advisable to work with an employment law attorney if there is any question as to the category of the relationship. The whole topic is made more complicated by the fact that different laws define the employment relationship in different ways. And that's just at the federal level. States have also put legislation in place that further defines who is considered an employee. The Affordable Care Act (ACA) gives employers one more reason to be careful about who they call an independent contractor. If employees are misclassified as independent contractors, the employer may owe penalties under §4980H (the "employer mandate") on top of the risk for paying back wages, tax penalties, and fines under the Fair Labor Standards Act (FLSA) and other IRS rules.

Independent Contractors

Employers (of any size) are not obligated to offer benefits for those individuals who are properly categorized as independent contractors. This is one of the many reasons why hiring independent contractors provides an appealing option to employers. Some employers want to offer benefits to independent contractors (for example, to attract the right talent), but we warn such employers to keep the following things in mind:

- Especially if the plan is fully insured, the carrier's group contract may have restrictions on covering individuals who are not employees. Check that out carefully so that the employer does not make an offer only to find out that the carrier will not honor claims.
- If the employer does offer benefits to independent contractors, such individuals would not be eligible to participate in the employer's cafeteria plan (available only to current or former employees), and benefits could not be provided on a tax-favored basis. Instead, contributions made by the independent contractor would need to be made on an after-tax basis, and employer contributions for such benefits probably need to be considered as additional compensation and included on the 1099; whether there would be any tax break for such benefits would need to be determined and handled by the individual.
- By covering a non-employee under the employer's group health plan(s), the employer creates a multiple employer welfare arrangement (MEWA). Plan documents would need to be updated accordingly, and the employer may need to file a Form M-1 along with a Form 5500 with the DOL each year (even if the plan has fewer than 100 participants). Form M-1 Instructions indicate that a small number of independent contractors will not create an M-1 filing obligation so long as the percentage of independent contractors is less than 1% of the employees and former employees covered under the plan. NOTE – although fully-insured MEWAs are generally okay so long as the carrier is willing to insure the arrangement, self-funded MEWAs are subject to a variety of licensing, financing, and reporting requirements under state law, and in some states, are even prohibited.
- Be very careful and consider the risks before offering any benefits to independent contractors. The IRS views this as a strong indicator that the individual is an employee rather than an independent contractor; therefore, the organization may want to consider whether offering benefits could jeopardize an individual's independent contractor status. Although an offer of coverage is only one of many factors considered, it would be advisable to run this situation by employment law counsel.

Staffing Agency Considerations

The determination of who is ultimately the common law employer can be difficult, especially between a staffing agency and a contracting company. If the individuals are hired by the staffing agency and placed with contracting employers, it is possible that the contract between the employer and the staffing agency will designate who is considered the common law employer. Regardless, we recommend obtaining advice that is based on the circumstances from an employment law attorney. For purposes of compliance with the employer mandate (§4980H) and associated employer reporting (§6056), see details below in regard to how these responsibilities play out.

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Common Law Employer – Contracting Employer (Applicable Large Employer)

If the contracting employer (rather than the staffing agency) is the common law employer, the contracting employer must track hours of service for the contracted employees in the same way it does for any other employees. Their hours of service would need to be included when determining whether the employer averaged 50 or more full-time equivalents (FTEs) and is therefore an applicable large employer. The contracting employer would be required to offer coverage if the employee is full-time (30 hours of service/wk or 130/mth) and to report on such coverage via Form 1095-C.

One possible way to satisfy the requirement for an offer of coverage is to have it offered through a staffing agency on behalf of the contracting employer; and then the fee paid for the employee must be increased accordingly. See language from §4980H rules below:

> *"...an offer of coverage to an employee performing services for an employer that is a client of a professional employer organization or other staffing firm (in the typical case in which the professional employer organization or staffing firm is not the common law employer of the individual) (referred to in this section IX.B of the preamble as a "staffing firm") made by the staffing firm on behalf of the client employer under a plan established or maintained by the staffing firm, is treated as an offer of coverage made by the client employer for purposes of section 4980H. For this purpose, an offer of coverage is treated as made on behalf of a client employer only if the fee the client employer would pay to the staffing firm for an employee enrolled in health coverage under the plan is higher than the fee the client employer would pay to the staffing firm for the same employee if the employee did not enroll in health coverage under the plan."*

If coverage is not offered that meets §4980H requirements, it would be the contracting employer who would be on the hook for any potential penalties. And regardless, it would be the contracting employer who is on the hook for reporting via Form 1095-C for such employees.

Common Law Employer – Staffing Agency (Applicable Large Employer)

If the staffing agency (rather than the contracting employer) is the common law employer, then the staffing agency is responsible for tracking hours of service, offering coverage if the employee is full-time (30 hours of service/wk or 130/mth), and reporting on such coverage via Form 1095-C. Some employers choose to play it safe, requiring the staffing agency to make a compliant offer of coverage to those who may be considered full-time, even if they feel confident that the individuals are truly independent contractors.

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Summary

For those individuals who meet the definition of an "employee," employers often choose to offer benefits; and in the case of an applicable large employer, are required to offer medical benefits to full-time employees to avoid potential penalties. The benefits offered to employees may generally be provided on a tax-favored basis. On the other hand, for those individuals who meet the definition of an "independent contractor," employers are not required to offer benefits, and we typically recommend that benefits not be offered. While there are a variety of risks beyond benefit offerings that may be involved in mislabeling individuals, the risk of mishandling benefits alone is worth employers' taking the time to make sure that their workforce is properly categorized as independent contractors or employees and treated accordingly.