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Client Alert Commentary

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10 Facts About the Affordable Care Act and Worker Classification

Businesses subject to the Affordable Care Act's "shared responsibility" provision must consider proper worker classification and its implications.

Although the Patient Protection and Affordable Care Act, as amended (ACA) was enacted to expand health insurance coverage in the United States, particular aspects of the ACA depend on whether someone is an "employee." Because the ACA links the number of employees a business has to its coverage responsibilities and penalties, the ACA focuses new attention on, and further complicates, the already tricky area of law governing the definition of "employee" and the proper classification of workers as either employees or independent contractors. This list highlights the ACA's requirements, the standards expected to apply in determining the number of employees for that purpose, the broader implications of proper worker classification and the serious risks of misclassification, as well as various existing remedial programs and guidelines for helping ensure workers are properly classified.

The ACA's "shared responsibility" provision requires that a "large employer" provide health coverage to its full-time employees and their dependents. Any "large employer" that fails to provide adequate and affordable health insurance will face penalties based on the number of its full-time "employees." Additionally, related data collection and reporting requirements also only relate to "employees." Therefore, every business needs to understand which of its workers qualify as "employees" (1) to determine whether it is a "large employer" under the ACA and (2) if it is a "large employer," to calculate any potential penalty.

1. **"Large Employer" Definition is Tied to the Number of Employees.** Under the ACA, a business will be subject to a penalty starting in 2015 if (1) it is deemed to be a "large employer" but (2) it does not offer its employees adequate and affordable health coverage as defined in the ACA, and (3) at least one of the business's full-time employees obtains a premium tax credit to help pay for health coverage purchased through an exchange.

   Therefore, the first step is determining whether a business is a "large employer." A "large employer" is defined as a business and all of its controlled group affiliates that together have an average of at least 50 full-time equivalent employees (FTEs) on business days during the preceding calendar year (or other elected look back period). A business has a FTE for every employee who works at least 120 hours per month. Therefore, the number of FTEs is calculated by counting the relevant employees' number of hours worked in a month and dividing that figure by 120. For example, a business with 15 employees who all worked 20 hours per week (80 hours per month) would have only ten FTEs (15 * 20 * 4 / 120).

   Because this test focuses on hours, a business needs to know which workers' hours to count. The hours worked by almost all of the business's full-time employees, part-time employees, and other types of employees (excluding certain seasonal and temporary agency employees) are

considered in calculating how many FTEs a business has. However, the test excludes all hours worked by independent contractors.

2. **But Penalties Are Tied Differently to the Number of Employees.** The amount of any penalty a large employer will owe under the ACA will depend on whether the large employer provided any health insurance coverage and, if so, whether such coverage met specific criteria regarding adequacy and affordability. If the large employer's coverage did not meet these criteria, one of two types of penalties will apply, both of which are based on the number of actual full-time employees.

   However, unlike the FTE calculation discussed above for determining whether a business qualifies as a "large employer," the penalty calculation is based on *actual full-time employees*. Because part-time employees are excluded from the calculation, this figure is often lower than the FTE figure.

3. **The ACA Defines "Employee" Ambiguously.** Although the ACA relies on the term "employee" for these two critical calculations, it lacks a useful definition of the term "employee" that might assist businesses in determining which workers count for purposes of each calculation.

   Instead, the ACA directs readers to the definition in the Employee Retirement Income Security Act of 1974 as amended (ERISA). However, the ERISA definition provides little clarity because ERISA defines the term "employee" to mean "any individual employed by an employer." Not surprisingly, Justice Souter, in his opinion in *Nationwide Mutual Insurance Company v. Darden*, 503 U.S. 318, 323 (1992), complained that this definition is "completely circular and explains nothing."

4. **The Common Law Definition of "Employee" Will Most Likely Apply for Purposes of the ACA.** Rather than ERISA's "circular" definition, proposed regulations suggest the ACA will apply the common law definition of "employee" for purposes of worker classification. For this purpose, the proposed regulations refer to the definition that applies for income tax wage withholding purposes.

5. **Common Law Asks Who Has the Right to Control and Direct a Worker.** Under the common law definition, whether a worker should be classified as an employee or an independent contractor will depend on whether the business has the right to control that worker. The wage withholding regulations explain that, generally, an employment relationship exists:

   > when the person for whom services are performed has **the right to control and direct** the individual who performs the services, not only as to **the result to be accomplished by the work** but also as to **the details and means by which that result is accomplished**. That is, an employee is subject to the will and control of the employer **not only as to what shall be done but how it shall be done.** In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; **it is sufficient if he has the right to do so**. Treas. Reg. §31.3401(c)-1(b) (*emphasis added*).

   After voicing disappointment with the ERISA definition, the Supreme Court in *Nationwide* also recognized a similar right to control test. The Court referred to a common law definition of "employee" as based on "the hiring party's **right to control the manner and means** by which the

product is accomplished." In other words, a worker should be classified as an employee only if the business can control not only what shall be done, but also how it shall be done.

Accordingly, a business should consider as a threshold matter whether it maintains the right to control a worker (even if it does not exercise such control) to determine whether that worker will be included in the headcount to determine whether the business is a "large employer" and, if the business is a "large employer," whether that worker would be included in calculating any penalty owed for failing to offer adequate and affordable health coverage.

6. **Right to Control Rests on a Multi-Factor Test.** To help determine whether a business maintains the right to control a worker, the Supreme Court, the US Tax Court, and the IRS (and many other federal and state authorities relying on some version of the common law test) look to a variety of factors. Although the sets of factors considered are not always identical, they overlap substantially. Consequently, to determine whether it has entered into an employment relationship with a worker for purposes of the ACA, a business should ask itself whether:

    - The worker is trained by the business or some other entity
    - The worker is required to comply with the business's instructions
    - The worker must submit regular or written reports
    - The work is required to be performed on the business's premises
    - The business furnishes or pays for the worker's tools, materials, other equipment and/or traveling expenses
    - The worker or the business works set hours
    - The worker is paid by the hour, week, or month instead of by project
    - The worker may and does work for other entities that are not affiliated with the business
    - The worker is required by the business to devote substantially full time to the business
    - The business, rather than the worker, hires, supervises and pays the worker's assistants
    - The business requires the worker to render the services personally
    - The worker's services are integrated into the business's operations
    - The worker and the business enter into a continuing relationship
    - The worker invests in the facilities used
    - The worker can realize a profit or suffer a loss as a result of his or her services
    - The business may discharge the worker at will
    - The parties believed they were creating an employment relationship

    No one factor is controlling. However, if, based on an overall analysis of the above factors, a business determines that it cannot control the manner and means by which the result is accomplished by the worker (rather, the worker controls the manner and means), then the worker may be classified as an independent contractor. As an independent contractor, that worker will not count in determining whether the business is a "large employer" under the ACA, and would not count in calculating any applicable penalty.

7. **Worker Classification Has a Wide Range of Legal Implications.** Classifying a worker as an independent contractor or as an employee could have a direct impact on the business's potential exposure to sanctions under the ACA. And, obviously, worker classification has long had important implications for businesses beyond the ACA. Worker classification decisions impact, for example, immigration and labor law compliance, payroll tax withholding and contribution requirements, as well as unemployment, workers' compensation, and similar employee welfare-type obligations. Worker classification decisions may affect the workers' rights under the business's retirement plans and qualified employee stock purchase plans, may impact the

workers' ability to seek damages against the business for, for example, wrongful termination or discrimination, and may determine the business's potential liability for a worker's negligent acts.

Importantly, a worker may be deemed an employee for purposes of one statute but still be considered an independent contractor for purposes of another. Because the rationales behind the laws are not uniform, different areas of law use slightly different tests to determine a worker's proper classification. For example, many federal laws (such as the Fair Labor Standards Act (FLSA)) and many state laws (such as workers' compensation and wage-hour laws) use a test called the Economic Reality Test to determine a worker's classification. The Economic Reality Test focuses on the purpose of the legislation under which the Test is applied. For example, if the purpose of the law, like the FLSA, is to protect workers who qualify as employees, then the Test will be applied in such a way as to increase the difficulty of classifying a worker as an independent contractor. The Economic Reality Test takes into account the usual common law factors discussed above, but supplements them with additional factors, including whether the worker is integral to the business and whether the worker is economically dependent upon the business. In contrast, worker classification tests utilized by laws supporting the imposition of taxes are generally construed more narrowly, such that independent contractor status might be more readily sustained.

Thus, proper worker classification may involve unexpected complexities. Businesses need to consider not only the implications of worker classification under the ACA, but also its implications under numerous other areas of law.

8. **Increasing Enforcement Risks Accompany Misclassifying Workers.** Arguably the ACA incentivizes certain businesses on the "cusp" of "large employer" status to maintain few enough employees to avoid the burden of "shared responsibility" requirements. And, for businesses that cannot avoid "large employer" status but may not offer adequate and affordable health insurance coverage, arguably the ACA incentivizes minimizing full-time employee counts to minimize penalties. Utilizing independent contractors may be an attractive option.

   Across the spectrum of industries, however, the widespread use of independent contractors in the workforce requires careful analysis to ensure proper worker classification and treatment. Given the risks associated with misclassifying workers, businesses need to approach worker classification with caution. Businesses face a significant risk of federal and/or state scrutiny of any worker classification. Reclassification in any context increases the potential for a "snowball" effect, with misclassification leading to multiple potential enforcement ramifications as well as the possible need to alter the business's workforce model.

   Pressures to generate additional revenue in recent years have led numerous states to pass more restrictive worker classification laws and to step up enforcement and examine businesses in connection with potential liability for misclassified workers. The federal government has also renewed its focus on businesses misclassifying employees as independent contractors.

   In 2010 the IRS launched an employment tax "national research project" to gather information about employment tax compliance. The IRS will conclude 6,000 audits by the end of 2013 through this project. The IRS also anticipates hiring thousands of new agents specifically to enforce the ACA and fight employee misclassification.

   The Department of Labor (DOL) is similarly taking rigorous steps to combat misclassification. The DOL's new "We Can Help" program encourages workers to partner proactively with the DOL if

they believe that they have been misclassified or are not being properly paid under federal labor laws. Significantly, the Obama Administration's 2014 budget proposal (2014 Budget Proposal) pertaining to the DOL allocates approximately $14 million to combat worker misclassification, including $10 million for grants to states to pursue worker misclassification and $4 million for the DOL's Wage and Hour personnel to investigate misclassification. In addition, the DOL has entered into Memoranda of Understanding with the IRS and several state agencies, whereby the agencies will share information regarding misclassified employees.

In the event businesses improperly classify employees as independent contractors, those businesses risk, at the state and federal levels, the potential for audits, taxes, penalties, interest, and other costs and obligations that arise in the event reclassification is required, the economic consequences of which could extend far beyond potential exposure under the ACA.

9. **Existing IRS Misclassification Relief May Not Be Extended to the ACA.** The IRS has created various programs to alleviate some of the financial burdens faced by businesses that have misclassified employees as independent contractors in the context of payroll taxes. However, whether any of these programs will be applied beyond the federal payroll tax withholding regime to help businesses who are deemed to have misclassified employees for ACA purposes remains unclear.

   The **Section 530 Safe Harbor** (which refers to Section 530 of the Revenue Act of 1978) is designed to provide certainty to both the business and the worker that independent-contractor status will be respected for federal employment tax purposes and can continue prospectively. Specifically, if businesses meet the requirements, the Section 530 Safe Harbor bars the IRS from reclassifying workers as employees for federal payroll tax purposes and subjecting the business to liability for federal employment taxes, penalties and interest with respect to the workers. Eligibility for the Safe Harbor is tied to proper information reporting, consistent historical treatment of the contractor class of workers and reasonable cause for the classification. Under other programs, including **Code Section 3509** (reduced retroactive rates), the **Classification Settlement Program** (available to taxpayers under audit), and the **Voluntary Classification Settlement Program** (available to taxpayers not under audit), businesses that fail to meet the Section 530 Safe Harbor requirements may otherwise qualify for various graduated forms of retroactive payroll tax relief, but must also agree to prospective reclassification of the workers as employees.

   Some commentators have urged the Treasury Department to incorporate the Section 530 Safe Harbor rules for purposes of implementing the requirements of the ACA. At the present time, however, businesses should realistically assume the Section 530 Safe Harbor and the other federal classification relief programs may not protect businesses that misclassify employees as independent contractors for purposes of the ACA's "shared responsibility" provision and related penalties. These federal programs may not be expanded to apply to the ACA, particularly in light of the fact that the 2014 Budget Proposal discusses potentially repealing the Section 530 Safe Harbor in the federal payroll tax context such businesses would still receive retroactive protection but no prospective safe harbor protection. The 2014 Budget Proposal also discusses limiting the Section 530 Safe Harbor waiver of penalties to only businesses with a "small" number of employees and a "small" number of misclassified workers.

10. **Businesses Can Reduce the Risk of Classification Disputes.** The implementation of the ACA presents a good opportunity for businesses to re-evaluate their workforce classification in light of the ACA's focus on "employee" status. In doing so, businesses should carefully consider the

factors under the common-law worker right to control test. In addition, following the steps below may help reduce the risks of worker classification problems:

- Establish written policies for engaging independent contractors and utilize a clear independent contractor agreement to which both parties adhere
- Select independent contractors with specialized skills to perform — over a fixed term — specialized services that are distinct from those rendered by employees
- Engage independent contractors who are incorporated or otherwise have an established trade or business
- Ensure a mutual understanding of the worker's independent contractor status, including the contractor's assumption of responsibilities for licensing and insurance exists
- Restrict the provision of training, traditional benefits, tools, work space and reimbursement provided to the independent contractors
- Do not restrict the independent contractors' ability to provide services to others
- Avoid using terms common to employment and wage payment
- Avoid disseminating an "Employee Manual" to contractors
- Do not issue business cards, identification, voicemail boxes or e-mail addresses to contractors

Businesses should consider more feasible alternatives, if appropriate, if there is doubt as to the proper classification of a worker as an independent contractor. Although the worker may not qualify as an independent contractor, he or she may qualify as a part-time employee or even a seasonal employee, which would still reduce the business's number of full-time employees for purposes of determining the amount of the potential penalty under the ACA. Also, businesses must always consider the impact of any related companies on their options.

Conclusion

The IRS and Treasury received more than 500 comments from businesses and various interested groups in response to the proposed regulations for implementation of the ACA. Many of these comments raised questions about the definition of the term "employee" and its implications on businesses for purposes of the ACA. Worker classification has always been a complex area of law, and the ACA only adds to this complexity. Latham's Tax Controversy, Benefits & Compensation, and Healthcare Practice Groups can provide guidance on the ACA, assist in structuring workforce relationships, deal with federal and state authorities scrutinizing worker status, evaluate existing worker classification issues and estimate exposure for misclassification in a variety of contexts.

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