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**THE IMPORTANCE OF PROPER WORKER CLASSIFICATION
AND CONTROLLED GROUP ANALYSIS UNDER THE
AFFORDABLE CARE ACT**

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I. Introduction

It is all too easy for employers and advisors to make assumptions about or overlook two key threshold aspects of the shared responsibility penalty provisions under the Affordable Care Act: (1) who is the “employer” for these purposes; and (2) whether the employer has properly classified its workers as employees or independent contractors.

All entities treated as a single employer under Internal Revenue Code (“Code”) Sections 414(b), (c), (m), or (o) are generally treated as a single employer for purposes of the Affordable Care Act (“ACA”), including the employer shared responsibility penalties under Code Section 4940H. Thus, the employees of all employers within a controlled group of trades or businesses and/or an affiliated service group are taken into account in determining whether the group is an “Applicable Large Employer” subject to reporting and penalties.

II. Who is the Employer?

A. Controlled Group Analysis. (Code Sections 414(b) and (c)).

Parent-subsidiary group: A chain of trades or businesses in which there is at least 80% ownership (direct or indirect) by a common parent.

Example: A owns 80% of B. B owns 80% of C. A, B and C form a controlled group.

Brother-sister group: If

(1) the same five or fewer persons own at least 80% of each trade or business; and

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- (2) taking into account the ownership of each such person only to the extent his ownership is identical with respect to each of the trades or businesses, these persons own more than 50% of each trade or business.

Example:

	<u>Organizations</u>						
<u>Individuals</u>	L	GHI	M	W	X	Y	Z
A	100%	50%	100%	60%	40%	20%	60%
B	0	40%	0	15%	40%	50%	30%
C	0	0	0	0	10%	10%	10%
D	0	0	0	25%	0	20%	0
E	0	10%	0	0	10%	0	0

4 Controlled groups:

- GHI, X and Z (via ownership by A and B)
- X,Y and Z (via ownership by A, B and C)
- W and Y (via ownership by A, B, and D)
- L and M (via ownership by A)

Combined Group: Any group of three or more organizations, if: (1) each such organization is a member of either a parent-subsidary group or a brother-sister group; and (2) at least one such organization is the common parent organization of a parent-subsidary group and is also a member of a brother-sister group.

B. Affiliated Service Group Analysis. (Code Section 414(m)).

An “affiliated service group” is a group consisting of a “First Service Organization” and:

- One or more A Organizations;
- One or more B Organizations; or
- One or more A Organizations and one or more B Organizations.

A Organization. A service organization is an A Organization if it:

- is a partner or shareholder in a First Service Organization which provides **professional services** (i.e., those performed by accountants, actuaries, architects, attorneys, medical doctors, dentists, professional engineers, optometrists, osteopaths, podiatrists, psychologists, and veterinarians); and
- regularly performs services for the First Service Organization, or is regularly associated with the First Service Organization in performing services for third persons.

Example – A Organization: Attorney N is incorporated, and the corporation is a partner in a law firm. Attorney N and his corporation are regularly associated with the law firm in performing services for third persons. The law firm is a first service organization and the corporation is an A Organization.

B Organization. A service organization is a B Organization if:

- a significant portion of the business of the organization is the performance of services for the First Service Organization, for one or more A Organizations determined with respect to the First Service Organization, or for both;
- those services are of a type historically performed by employees in the service field of the First Service Organization or the A Organizations; and
- ten percent (10%) or more of the interests in the organization are held, in the aggregate, by persons who are officers, highly compensated employees, or common owners of the First Service Organization or of the A Organizations.

An organization may be a B Organization even though it is not a service organization.

Example - B Organization: Partnership R is a dental practice that has 11 partners. Each partner of R owns five percent (5%) of the stock in Corporation D, a dental lab. The corporation provides services to the partnership of a type historically performed by employees in the dental practice and a significant portion of the business of the dental lab consists of providing services to the dental practice. The partnership is a first service organization and the corporation is a B Organization.

Multiple Affiliated Service Groups: If an organization is a First Service Organization with respect to two or more A Organizations or two or more B Organizations, or both, all of the organizations shall be considered a single affiliated service group, or there may be multiple affiliated service groups.

C. Anti-Abuse and Employee Leasing Rules. (Code Section 414(o)).

The regulations under Code Section 414(o) include anti-abuse rules and rules surrounding employee leasing.

D. Ownership Attribution.

The following general rules of attribution of ownership apply:

- **Attribution from partnerships:** An interest owned, directly or indirectly, by or for a partnership is deemed owned by any partner having an interest of five percent (5%) or more in either the profits or capital of the partnership in proportion to that partner's interest.
- **Attribution from estates or trusts:** An interest owned, directly or indirectly, by or for an estate or trust is deemed owned by any beneficiary of the estate or trust who has an actuarial value of five percent (5%) or more in the interest.
- **Attribution from corporations:** An interest owned, directly or indirectly, by or for a corporation is deemed owned by any person who directly owns five percent (5%) or more in value of the stock in proportion to the value of the person's stock relative to the total value of the corporation's stock.
- **Spousal Attribution:**
 - An individual is deemed to own an interest owned, directly or indirectly, by or for his or her spouse, unless:
 - The individual does not directly own any equity in the spouse's trade or business;
 - The individual is not a director or employee and does not participate in the management of the spouse's trade or business;
 - The spouse's trade or business does not generate more than 50% passive income for the tax year; and
 - The spouse's ownership interest is not subject to transfer restrictions running in favor of the other spouse or his or her minor children.

(This exception may not apply in a community property state unless the ownership interest held by the spouse is separate property.)
 - There is no attribution to a spouse who is legally separated from an individual under a decree of divorce or separate maintenance.
- **Attribution to and from children and parents:**
 - An individual is deemed to own an interest owned, directly or indirectly, by or for his or her children who have not attained age 21. (There is no attribution between a parent and children who are age 21 and over.)

- An individual under age 21 is deemed to own an interest owned, directly or indirectly, by or for his or her parents.

III. Proper Worker Classification.

Proper worker classification is more important than ever, given the ACA's penalty regime.

- Example 1: Employer X concludes that it is not an Applicable Large Employer because it employed only 45 full-time equivalent employees. However, the results of an IRS audit indicate Employer X misclassified eight of its full-time workers as independent contractors. Thus, Employer X was actually an Applicable Large Employer subject to the ACA's penalty and reporting regime for Applicable Large Employers.
- Example 2: Employer Y is an Applicable Large Employer who provides affordable, minimum value, minimum essential coverage for 190 of its 200 full-time employees. Employer Y also utilizes a group of 20 independent contractors that a government agency later reclassified as employees. In addition to other taxes and penalties, Employer Y could be subject to substantial ACA penalties under Code Section 4980H for failing to offer these employees minimum essential coverage.

The financial risks of misclassification are compounded by the fact that reclassification may be retroactive.

A. **The Evolving Common Law Definition of Employee**

- Under federal common law rules, an employment relationship generally exists when the person for whom the services are performed has the ***right to control*** and direct the individual performing the services, not only as to the result to be accomplished, but also as to the ***details*** and ***means*** by which that result is accomplished. It is not necessary for the employer to ***actually*** direct or control the manner of performance.
- If an individual is subject to the control or direction of another person merely as to the ***result*** to be accomplished and not as to the ***means*** and ***methods***, then the individual is likely an independent contractor.
- Designation of the relationship by the parties as independent contractor status is not controlling if an employment relationship actually exists.

B. **Revenue Ruling 87-41.**

- Issued in 1987 and intended to provide guidance as to the factors used to determine whether an employment relationship exists.
- Identified twenty common law factors (discussed below) used by the IRS and courts up to that time. It became the standard by which subsequent determinations were made.

C. The Evolving “20-Factor Test.”

Since issuing Revenue Ruling 87-41, the IRS has modified and updated its approach to worker classification. In an attempt to ensure the focus is on the “right to control,” the IRS now encourages its agents to look beyond the twenty factors in Revenue Ruling 87-41 and to focus on three categories of factors—Behavioral Control Factors, Economic Control Factors, and Relationship Factors. IRS Publication 1779 outlines the various factors, including:

Behavioral Control Factors.

- **Factor 1: Instructions.** A worker who is required to comply with another person’s instructions as to when, where, and how the work is to be performed is ordinarily an employee.
- **Factor 2: Training.** Training a worker as to the method and manner of performing services indicates control and the existence of an employment relationship.
- **Factor 3: Hiring, Supervising, and Paying Assistants.** If the person for whom the services are performed hires, supervises, and pays all assistants, then an employment relationship is generally indicated.
- **Factor 4: Setting Hours of Work.** The establishment of set hours of work by the person requesting the services is a factor indicating control and the existence of an employment relationship.
- **Factor 5: Full Time Requirement.** If the worker must devote substantially full time to the business of the person requesting the services, the worker is impliedly controlled and restricted from performing other gainful work, which indicates the existence of an employment relationship.
- **Factor 6: Work on Taxpayer’s Premises.** Work performed on the premises of the person requesting the services indicates the latter person has control over the manner of performance, especially if such work could be performed elsewhere.
- **Factor 7: Work Order or Sequence.** If another person can require a worker to perform services in a certain order or sequence (or follow established routines or schedules), then the worker is subject to control, which indicates an employment relationship exists.
- **Factor 8: Requiring Reports.** If a worker is required to submit regular or written reports to the person for whom services are performed, then the latter person has some degree of control over delivery of the services, which may indicate an employment relationship exists.

Economic Control Factors.

- **Factor 9: Tools and Materials.** An employment relationship is indicated if the

person for whom services are performed furnishes significant tools, materials, and other equipment to the person performing the services.

- **Factor 10: Significant Investment by Worker.** If a worker invests in facilities or equipment used to perform services and which are not typically maintained by employees, independent contractor status is indicated.
- **Factor 11: Payment of Expenses.** If the person for whom services are performed pays the worker's business or travel expenses, the worker is ordinarily an employee.
- **Factor 12. Payment by the Hour, Week, or Month.** Payment by the hour, week, or month generally indicates an employment relationship; provided, however, that this method of payment is not merely a convenient way of paying an agreed-upon lump sum for the particular job. Payment of straight commission or payment by the job or task generally indicates the worker is an independent contractor.
- **Factor 13: Economic Risk of Profit or Loss.** A worker who can realize a profit or loss from the performance of services over and above the profit or loss ordinarily realized by an employee is generally an independent contractor. The worker who cannot realize such profit or loss is generally an employee.
- **Factors 14 and 15: Making Services Available to the General Public; Working for Multiple Persons.** These factors are interrelated. Independent contractor status is indicated when workers make their services available to the general public on a regular and consistent basis. A worker performing services for multiple unrelated parties at the same time is likely an independent contractor, while a worker performing services for one person or performing services for several persons as part of the same service arrangement is likely an employee of such person(s).

Relationship Factors.

- **Factor 16: Integration.** The degree to which a worker's services are integrated into the business operations of the purported employer generally shows the extent to which the worker is subject to direction and control. More extensive integration indicates the existence of an employment relationship.
- **Factor 17: Personal Rendering of Services.** When services must be rendered personally, the person requesting the services is presumably interested in both the result and the methods used to accomplish the result, which indicates the existence of an employment relationship.
- **Factor 18: Continuing Relationship.** A continuing relationship between the worker and the person requesting the services, including performance at frequently-recurring but irregular intervals, indicates the existence of an employment relationship.
- **Factors 19 and 20: Right to Discharge; Right to Terminate.** These factors are also related. The right to discharge a worker indicates an employment relationship.

An independent contractor typically cannot be discharged so long as he or she produces a result that meets the parties' contracted specifications. Similarly, if a worker has the right to terminate the relationship at any time without liability, an employment relationship is indicated.

Additional Considerations.

Additional factors and considerations exist outside the twenty factors of Revenue Ruling 87-41. Courts have also looked to factors such as:

- Industry practice or custom;
- The intent of the parties;
- The existence of written, signed independent contractor agreements;
- The provision of employee benefits; and
- Whether the work requires special skills.

IV. Conclusion.

Proper worker classification and controlled group/affiliated service group analysis is imperative. Employers who fail to properly address these threshold issues run the risk of significant adverse consequences, including the ACA's shared responsibility penalties under Code Section 4980H. Employers and benefits professionals should be aware of these issues, and employers should seek legal advice when necessary.

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