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Key Issue for PEOs and COBRA: Who's the Boss?

By Rich Glass, JD

A TV sitcom in the 1980s asked the age-old question: "Who's the Boss?" Depending on which episode you watched, the answer might be the female executive or the male housekeeper. In some episodes, both characters showed boss-like characteristics.

That same question is operative when assigning COBRA responsibility for employees of a professional employer organization (PEO). And the same answer applies as well: it depends.

As a starting point, COBRA regulations make it clear that the employer is responsible for health plan compliance. What's less clear is who the employer is. In other words, who's the boss? On the one hand, the boss could be the PEO. A PEO is an organization that helps client companies outsource their labor-related needs by providing workers and handling administrative matters like payroll, human resources (HR) and benefits. On the other hand, the boss could be the client company. After all, these people are working at the client company's worksite, performing tasks that further the client company's business.

This is no small issue. Often, the reason the client company seeks out a PEO is that it is small and has a need for only a handful of workers, much fewer than COBRA's threshold of 20. If the client company is deemed to be the employer, then it might qualify for COBRA's small employer exception. If the PEO is the employer, COBRA will apply.

Two Important Tests

Two tests exist for determining where the employees belong: the common-law employee test and the leased employee test. Under the first test, the IRS looks at as many as 20 different factors, found in Revenue Ruling 87-41, for determining who controls the work of the employees. The PEO may be described as the employer in the PEO agreement. The PEO may provide payroll and benefits. But these factors alone do not always mean that the PEO is the employer. If the client company is primarily responsible for directing, training and setting hours, these factors could turn the client company into the employer. Ultimately, you should examine which party has the right to control the performance of services.

When Are Leased Workers Treated as Employees?

Under a Code Section 414(n) test, leased PEO workers are treated as employees of a recipient client company when three factors are present:

1) A leasing agreement exists between the client company and the PEO.
2) The individual performs services on a substantially full-time basis for at least one year.
3) Services are under the primary direction or control of the client company.

Even if the PEO is deemed to be the employer under the first test, certain leased employees of the PEO are automatically considered employees of the recipient client company. This test is found in Section 414(n) of the Internal Revenue Code. (See box above.)

When the PEO is considered the employer, it becomes responsible for COBRA administration. An employee who works for multiple PEO client companies in a given year is included in the PEO count. By the same token, an employee who moves from one PEO client company to another without a break in employment generally would not experience a COBRA qualifying event.

When the client company is considered the employer, the analysis is a little more

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complicated. A health plan that provides coverage to two or more employers is a multiple employer welfare arrangement (MEWA). In virtually all cases, a MEWA is not considered the employer. Instead, it transforms each employer into a separate plan sponsor, typically with the PEO taking on plan administration duties. Thus, the small employer exception would apply separately to each employer. Also, changing PEO client companies would be considered a termination of employment.

Another Possibility

As with the TV sitcom, there is a third possibility. Based on the *Vizcaino v. Microsoft* case, where staffing agency employees were ruled to be eligible for Microsoft benefits, some courts may hold that both the PEO and the client company are co-employers. Proposed regulations issued in February 2008 regarding the Family and Medical Leave Act (FMLA) also recognize joint employment between the PEO and client company in certain situations. And finally, many PEO agreements will identify the PEO and client company as co-employers. This can make the COBRA responsibility more difficult to determine, as a 2005 case revealed.

In *Delcastillo v. Odyssey Resource Management,* the client company and PEO were co-employers. When an employee became disabled, the client company was the health policyholder, not the PEO. The client company continued to provide health coverage for the employee and his spouse for over two years even though he never returned to work. Ultimately, the client company turned over health plan responsibilities to the PEO, which replaced the employer's old policy. Because the employee was no longer working, the PEO terminated coverage. After some dispute, the PEO offered the Delcastillos COBRA coverage. Instead of electing COBRA, they elected to sue.

After a large trial court award for the Delcastillos, the appeals court held there were no COBRA violations. The PEO offered COBRA when coverage terminated and thus was not responsible for any prior conduct by the client company, which had undergone a change in ownership during that time. While the appeals court ruled in the PEO's favor, it noted the danger of co-employment: "a PEO organization that uses multiple corporate entities to frustrate the recovery of valid ERISA claims might become subject to drastic ERISA remedies."

Frustration was added to confusion for another employee in *Kobold v. Aetna U.S. Healthcare.* Again, the PEO and client company were co-employers by contract. During the five months that he worked for the client company, the employee tried to apply for health plan coverage twice with a representative of the client company. His paperwork was never filed. Thus, when his employment terminated, there was no COBRA qualifying event because no loss of coverage occurred.

Two Tips

Let's be clear. PEOs serve an important function in the U.S. economy. According to statistics from the National Association of PEOs, some 2 million to 3 million employees work in a PEO arrangement in all 50 states. Last year, PEO revenues topped an estimated $60 billion. In many cases, these workers have access to benefits and legal protections that they would never receive otherwise working for a small employer.

Employers working with PEOs should do at least two things.

1) Read the PEO agreement carefully and make sure you understand its provisions.

2) Clarify important benefits responsibilities like COBRA, enrollments and providing important disclosures like summary plan descriptions and those required under laws like FMLA and HIPAA.

After all, it essentially boils down to one question: Who's the boss?