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EMPLOY

EE LEASING

The Risks for Lessees

In the increasingly popular practice of employee leasing, a "professional employer organization" (PEO) hires employees and leases them to a company needing their services (lessee). The lessee pays the PEO for the workers' services at agreed-upon rates sufficient to cover the workers' net wages, payroll taxes and benefits, and profit for the lessor. Some employers have transferred their entire work force to a PEO and "leased" it back, believing that in so doing they have relieved themselves of their obligations under employment tax laws, employee benefit laws, and labor and employment laws. Those employers may be surprised to learn that they likely remain liable for noncompliance with those laws, as legal standards defining the employer/employee relationship are not so easily overcome.

EMPLOYMENT TAX LAWS

The definition of an employer-employee relationship is the same under the federal income tax withholding statute,[1] the Federal Deposit Insurance (Social Security) Act,[2] and the Federal Unemployment Tax Act:[3]

> *Generally the relationship of employer and employee 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. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.*[4]

Under this definition, leased workers would nearly always be regarded as employees of the lessee.

Further, regulations under the federal income tax withholding statutes,[5] the Social Security Act,[6] and the Federal Unemployment Tax Act[7] provide:

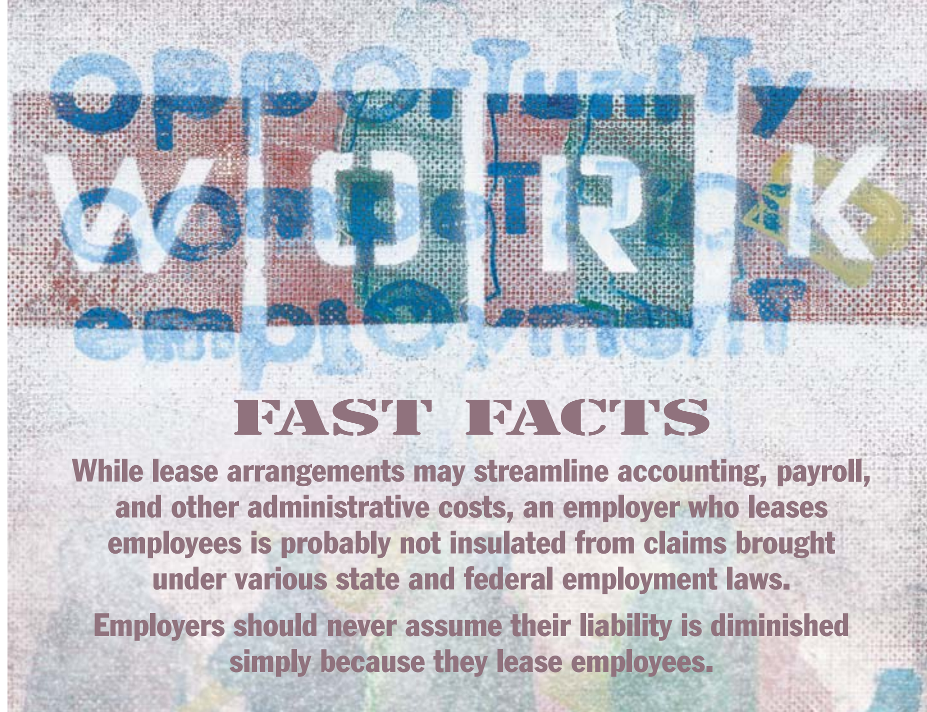
> *If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, independent contractor, or the like.*

Finally, under the Supremacy Clause of the U.S. Constitution, the IRS is not bound by leases, contracts, or other creatures of state law that purport to create, or renounce, employment status. Accordingly, taxing authorities may look to the substance of the employer's relationships when determining which parties should be considered employees, regardless of how the parties themselves portray their relationship.

The illustrative case of *In re Professional Security Services, Inc*[8] involved a company (PSSI) that hired security guards and placed them in condominium complexes. PSSI provided guards with written work rules and regulations, performed polygraph tests on them, tested them for drug usage, and supervised them. After PSSI filed a Chapter 11 bankruptcy petition in 1992, it entered into an agreement with Payroll Transfers, Inc. (PTI), under which PTI hired PSSI's guards and leased them back to PSSI. After the transfer of guards to PTI, PSSI continued supervising the guards. However, PTI undertook to pay the guards and related employment taxes, and filed employment tax returns as to them. When PTI failed to pay Social Security and FUTA taxes as to the guards, the IRS filed an administrative claim for the taxes in PSSI's Chapter 11 case. The U.S. Bankruptcy Court for the Middle District of Florida denied PSSI's motion for summary judgment on the IRS' claim, holding that the guards remained employees of PSSI.[9]

The *Professional Security* case comports with the IRS Chief Counsel's advice to IRS field personnel regarding federal employment tax treatment of PEO client companies as employers of workers they had leased from the PEO. For example, in Revenue Ruling 87-41,[10] the IRS cataloged 20 common law factors for determining the existence of an employer-employee relationship, regardless of the parties' own interpretation of their relationship. In Letter Ruling 200415008, Chief Counsel's office further noted that two employers can simultaneously employ the same worker. Letter Ruling 200415008 involved a PEO that had filed a Chapter 7 bankruptcy case and owed substantial amounts of federal employment taxes on workers it had leased to its clients. Chief Counsel's office advised that, if a worker is a common law employee of a client, the client is liable for accrued but unpaid federal employment taxes on the worker, notwithstanding the contractual relationship between the PEO and the client.

Clearly, if an employer decides to lease employees from a PEO, the employer should take steps to assure itself that the PEO is performing all federal and state employment tax obligations as to the leased employees. Employers should also note that the terms "employee" and "employer" have the same meaning under the Michigan Income Tax Act of 1967 as they do under the federal income tax withholding statutes.[11] Consequently, if a lessee is subject to federal income tax withholding on its leased workers' wages, it is also subject to Michigan income tax withholding on those workers' wages.



FAST FACTS

While lease arrangements may streamline accounting, payroll, and other administrative costs, an employer who leases employees is probably not insulated from claims brought under various state and federal employment laws.

Employers should never assume their liability is diminished simply because they lease employees.

RETIREMENT PLAN LAWS

Internal Revenue Code (IRC) Section 414(n) addresses the lessor-lessee relationship for purposes of the minimum participation standards of IRC Section 410 and other provisions of the IRC affecting qualified employer benefit plans. IRC Section 414(n)(1) provides that, with respect to any person (recipient) for whom a leased employee performs services:

- the leased employee shall be treated as an employee of the recipient; and
- contributions or benefits provided by the lessor that are attributable to services performed for the recipient shall be treated as provided by the recipient.

"Leased employee" for this purpose means any person not an employee of the recipient who provides services if:

- such services are provided pursuant to an agreement between the recipient and any other person (lessor);
- such person has performed such services for the recipient (or for the recipient and related persons) on a substantially full-time basis for a period of at least one year; and
- such services are performed under the primary direction and control of the recipient.[12]

An action for benefits under a plan governed by the Employee Retirement Income Security Act of 1974 (ERISA) may be brought only by a "participant" in or a "beneficiary" of the plan.[13] ERISA defines "participant" as "any employee or former employee of an employer . . . who is or may become liable to receive a benefit of any type from an employee benefit plan . . . or whose beneficiaries may be eligible to receive any such benefit."[14] In *Nationwide Mutual Ins Co v Darden,*[15] the Supreme Court held that, for purposes of ERISA, common law agency principles determine whether an individual is an employee.

In 1995, temporary employees of the Pacific Coast & Electric Co. (PC&E) sued for benefits under PC&E's employee benefit plans despite their nominal status as employees of Stafco, a PEO created by the parent company. The district court in *Burrey v Pacific Coast & Electric Co* held that, due to PC&E's lease with Stafco, the plaintiffs were not employees of PC&E, and dismissed the case.[16] On appeal, the Ninth Circuit held that, notwithstanding the leases, the 20 common law factors of Rev. Rul. 87-41 determined whether the plaintiffs were employees of PG&E. The court of appeals remanded the case to the district court for reconsideration of the plaintiffs' employment status.

However, in the similar case of *Anne Navey Clark v E.I. DuPont de Nemours & Co,* the Fourth Circuit Court of Appeals held that, where the defendant had always expressly excluded leased employees from its benefit plans, the plaintiff was not entitled to participate in the benefit plans at issue. It would appear that an employer wishing to ensure that leased workers are excluded from its employee benefit plans (and, hopefully, to avoid related litigation) should not only carefully review the 20 factors of Rev. Rul. 87-41 to make sure they do not weigh in favor of an employer-employee relationship, but also make sure the plan documents expressly exclude leased or contractual workers from participation.

FEDERAL AND MICHIGAN EMPLOYMENT LAWS

The Fair Labor Standards Act (FLSA)[17] regulates workers' wages, hours, overtime, and related matters. Regulations issued by the Department of Labor (DOL) apply the FLSA to situations where two employers simultaneously employ the same employee ("co-employment" or "joint employment"), and specify that joint employment may exist where (1) there is an arrangement between employers to share the employee services; (2) one employer is acting in the interest of another employer in relation to the employee; and (3) the employers may be "deemed to share control" of the employee. In a joint employment situation, both employers can be held liable under the FLSA as to their joint employee.

Joint employers also risk potential liability under the National Labor Relations Act.[18] In April 2004, the D.C. Circuit Court of Appeals[19] affirmed an NLRB ruling that Dunkin' Donuts and Aldworth Co. (which leased employees to Dunkin' Donuts) were joint employers who had committed numerous violations of the NLRA, including refusal to recognize and bargain with the employees' union while undermining union support by preventing a fair election. The Board ordered that Dunkin' Donuts and Aldworth offer reinstatement to employees who were unlawfully discharged, compensate employees for

losses, purge files on employees who suffered illegal discharges or discipline, post remedial notices, and engage in collective bargaining with the union.

The Equal Employment Opportunity Commission enforces civil rights under various federal statutes and provides oversight and coordination of all federal equal employment opportunity regulations, practices, and policies. In 1997, the EEOC issued enforcement guidance on the application of EEO laws to contingent workers placed by temporary employment agencies and "other staffing firms."[20] The guidance addressed the application of Title VII and the ADEA, ADA, and EPA to individuals placed in job assignments by temporary employment agencies and other staffing firms, specifically contingent workers. The EEOC identified as "contract firms" those that contract with a client to perform a certain service on a long-term basis and place their own employees, including supervisors, at the client's work site to carry out the service. Like a temporary employment agency, a "contract firm" typically recruits, screens, and hires its workers, and sometimes trains them. A contract firm pays workers, withholds employment taxes from their wages, and provides them with workers' compensation coverage.

The EEOC described a model in which an employer transfers its employees to a "staffing firm" and leases them back for the purpose of transferring to the staffing firm responsibility of administering wages and insurance benefits as to the leased employees. The EEOC concluded that the staffing firm did not have the right to exercise control over the leased employees, and that the staffing firm would not be considered the leased employees' employer. While the facts must be analyzed to determine whether a leased employee is an employee of the staffing firm (lessor) or the lessee in a given situation, there is a strong likelihood that the lessor and the lessee would be considered joint employers of the leased employee. In this situation, the employee count from both the lessor and the lessee is combined to determine whether the joint employers have the requisite number of employees for the Act to apply to them.

If the lessor and the lessee are determined to be joint employers, the EEOC has said that they are jointly and severally liable for wages and other compensatory damages under laws enforced by the EEOC. Punitive damages, under Title VII and the ADA, and liquidated damages under the ADEA, are individually assessed and borne by each respondent in accordance with its respective degree of maliciousness or reckless misconduct.

Conclusion

While lease arrangements may streamline accounting, payroll, and other administrative costs, an employer who leases employees is probably not insulated from claims brought under various state and federal employment laws. Potential joint employer liability can sometimes appear unexpectedly; for example, it is unlikely that Wal-Mart ever expected to be charged with knowingly employing illegal workers when its subcontractors had 345 undocumented foreign workers arrested. However, Wal-Mart has reportedly agreed to pay $11 million to settle the federal investigation, and its employee leasing arrangement is partially responsible.[21] Employers should never assume their liability is diminished simply because they lease employees. ◆

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Footnotes

1. 26 USC 3401–3406.
2. 26 USC 3101–3128.
3. 26 USC 3301–3311.
4. 26 CFR 31.3401(c)-1(b), 31.3121(d)-1(c)(2), 31.3306(I)-1(b).
5. Treas Reg 31.3401(c)-1(e).
6. Treas Reg 31.3121(d)-1(a)(3).
7. Treas Reg 31.3306(i)-1(d).
8. Docket No 92-5776-8P1, 1993 TNT 240-27, 94-1 USTC ¶ 50,148 (Bankr, MD Fla, Nov. 4, 1993).
9. See *United States v Imre Garami,* Docket No 94-1261-CIV-ORL-19, 1995 TNT 147-8, 76 AFTR2d ¶ 95-5163, 95-2 USTC ¶ 50,520 (MD Fla Jun 28, 1995). See also *In re Earthmovers, Inc,* 96-2 USTC ¶ 50,549 (Bankr, MD Fla Aug 7, 1996).
10. 87-1 CB 296.
11. MCL 206.8.
12. In Publication 560, the IRS made an exception to the requirement that a leased employee be treated as an employee of the recipient where the leased employee is covered by a money purchase pension plan of the lessor providing full and immediate vesting and a nonintegrated employee contribution of at least 10 percent of compensation for each participant.
13. 29 USC 1132(A)(1).
14. 29 USC 1002(7).
15. 503 US 318 (1992).
16. 159 F3d 388 (CA 9, 1998). See also *Vizcaino v Microsoft Corporation,* 173 F3d 713 (CA 9, 1999), cert. denied, 120 S Ct 844 (2000).
17. FLSA, 29 USC 201 et seq.
18. 29 USC 151 et seq.
19. *Dunkin' Donuts Mid-Atlantic Distribution Center Inc v NLRB,* No 02-1334, April 2, 2004.
20. EEOC Notice No 915.002, Dec. 1997.
21. Barbaro, *Wal Mart to Pay $11 Million,* Washington Post, Mar. 19, 2005.