Brown & Brown

EMPLOYEE BENEFITS

Health and Welfare Benefit Plan Compliance Considerations for Employers Using Professional Employer Organizations (PEOs)

Many businesses enter contractual arrangements with third-party companies, known as professional employer organizations (PEOs), to fulfill staffing needs and outsource other administrative functions. In the typical PEO arrangement, the PEO contractually assumes the responsibility for paying and providing benefits to workers ("PEO workers") who perform services for the PEO's client (the "client employer").

Obtaining workers through this arrangement may raise certain employee benefit compliance concerns for the client employer. Before entering such arrangements, client employers should seek the advice of their legal counsel to ensure that the arrangement is structured properly to comply with applicable federal and state laws.

This article identifies some key issues companies that use or plan to engage the services of a PEO should review with their legal counsel, including:

1. Is there an obligation under the Affordable Care Act's (ACA) employer- shared responsibility rules to offer the PEO workers coverage? Who is responsible for the ACA reporting obligations related to offers of coverage and/or the provision of coverage?
2. Does the provision of coverage to the PEO workers create a MEWA, and if so, what, if any, ERISA obligations does this create for the client employer?
3. Are PEO workers able to make pre-tax salary reduction contributions for health and welfare benefits?
4. Who is responsible for complying with the various COBRA notice obligations?
5. What compliance-related issues arise when the client employer terminates its contract with the PEO?

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EMPLOYER SHARED RESPONSIBILITY PENALTIES/ACA REPORTING

Under the ACA, Applicable Large Employers (ALEs) that do not offer certain health coverage to their full-time, common-law employees face potential penalties under Internal Revenue Code (IRC) Section 4980H ("employer shared responsibility penalties" or "ESRPs"). ALEs are employers who employed an average of 50 or more full-time employees and full-time equivalent employees in the prior calendar year. Under the ESRP regulations, the common-law employer is the entity subject to ESRP liability. In the context of a business contracting with a PEO, the question is whether the PEO or the client employer is the common-law employer of the PEO workers.

The IRS has provided guidance on this issue. The preamble to the employer-shared responsibility final regulations notes in regard to PEO workers, "in the typical case . . . the professional employer organization or staffing firm is not the common law employer."[1] Accordingly, in the typical case, the common law employer of PEO workers will likely be the client employer rather than the PEO itself, meaning that potential ESRP liability will typically fall on the client employer rather than the PEO (assuming the client employer is an ALE).

Note: While the IRS suggests that PEOs are typically not considered the common law employer of PEO workers for ESRP purposes, determining whether such employees are the client employer's common law employees is fact-specific and should be determined with the assistance of employment law counsel.

For client employers that are ALEs and are the common law employers of the PEO workers, the final regulations provide that an ALE can take credit for coverage offered by a staffing firm or PEO. However, it can only do so if the client employer pays an extra fee to the PEO:

> *[I]n cases in which the staffing firm is not the common law employer of the individual and the staffing firm makes an offer of coverage to the employee on behalf of the client employer under a plan established or maintained by the staffing firm, the offer is treated as made by the client employer for purposes of section 4980H 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 the staffing firm for the same employee if that employee did not enroll in health coverage under the plan.*[2]

This rule provides relief to client employers who are ALEs that contract with either a staffing agency or PEO and wish to avoid potential penalties under the ACA's employer-shared responsibility provisions. The rule does not, however, specify the amount of the required extra fee, nor is there specific guidance on how the extra fee is calculated or how a client employer can account for paying it. As a result, a client employer that is an ALE should discuss these issues with qualified legal counsel when entering into a contract with a PEO.

Although there is relief for common law employers that utilize PEOs/staffing agencies in the final ESRP regulations, the ACA reporting regulations (i.e., rules related to Forms 1094/1095-C) do not provide corollary relief to ALEs. Under those rules (found in Section 6056 of the IRC), Form 1094/1095-C reporting obligations rest with the client employer if it is the common law employer of the PEO workers under IRS rules. The Section 6056 rules generally do not allow someone who is not the common law employer of an employee to complete Forms 1094/1095-C using its EIN (rather than the common law employer's EIN). Thus, if a PEO completes Form 1094/1095-C reporting under its name and EIN rather than the client employer's EIN, and the client employer is the common law employer, the client employer could potentially be subject to penalties for failing to file a return related to its common law employees.[3]

A similar issue exists under the ACA reporting requirements applicable to providers of minimum essential coverage, which are found in Section 6055 of the IRC. If the group medical plan sponsored by the PEO is fully insured, the insurance carrier will report the employees/individuals enrolled in the coverage using Forms 1094/1095-B. However, suppose the medical plan sponsored by the PEO is self-insured. In that case, the rules provide that the responsibility to report for enrollees of the self-insured medical plan falls on "[e]ach participating employer (for its own employees) for a plan or arrangement maintained by a Multiple Employer Welfare Arrangement." Therefore, if the PEO's plan is self-insured and constitutes a MEWA as discussed below, the client employer would be the reporting entity that is responsible for the reporting of the employees/individuals enrolled in the self-insured medical coverage provided under the PEO's MEWA.

[1] 79 Fed. Reg. 8543, 8566.
[2] 79 Fed. Reg. 8543, 8566.
[3] The PEO might agree to prepare the forms on behalf of a client employer using the client employer's EIN. Nevertheless, the client employer has the legal responsibility for distributing and filing the forms.
[4] Instructions for Forms 1094-B and 1095-B.

MEWA

Under ERISA, a multiple employer welfare arrangement ("MEWA") generally exists when a health or welfare plan covers the common law employees of two or more employers. The DOL has indicated that a plan sponsored by a PEO that covers the employees of two or more client employers (where the workers are the common law employees of the client employers[5]) is a MEWA under ERISA:

> A PEO plan or arrangement that offers or provides health coverage to employees of two or more client employers, or employees of both the PEO and one or more client employers, is a MEWA under [ERISA] Section 3(40) because it offers or provides benefits to employees of two or more employers.[6]

Status as a MEWA raises a number of compliance-related issues:

- Generally, state insurance law can apply to fully insured MEWAs "to the extent it provides standards requiring the maintenance of specified levels of reserves and contributions." In contrast, MEWAs that are not fully insured may be subject to state insurance law "to the extent such law is not inconsistent with Title I of ERISA."[7] Accordingly, when a PEO's plan is considered a MEWA, the plan will be subject to state insurance regulations.
- MEWAs may be subject to annual Form M-1 filing requirements when there is less than 25% common ownership among the participating employers and the plan provides health care benefits.[8] Failure to timely file Form M-1 can lead to an assessment of civil penalties of $1,881 per day (2023; as indexed for inflation) under ERISA. The Form M-1 filing obligation falls on the "administrator" of the MEWA, which typically will be the PEO.
- How various ERISA requirements are met for a MEWA, such as applicable Form 5500 reporting requirements[9], and how plan documents and SPDs are structured depends upon whether sponsorship of the ERISA plan is at the participating employer level (i.e., each participating employer maintains the ERISA benefit plan for its own employees) or at the MEWA level.[10]

DOL guidance suggests that in the typical PEO situation, sponsorship of the ERISA plan will be at the participating client employer level because client employers do not share in the investments, income, contracts, leases or other financial activities of the other client employers (commonality of economic interest) or they are not members of a trade association that is recognized by state law (associative interest). Under the DOL guidance, issued in the form of advisory opinions, the ERISA plan will exist at the MEWA level only when the different employers participating in the MEWA have both a "commonality of interest" (economic or associative) and "control" over both the plan and the functions and activities of the group of employers participating in the MEWA.

Accordingly, assuming the PEO's health plan that covers the common law employees of its client employers is a MEWA, the ERISA plan likely exists at the client employer level because each client employer does not have "control" over both the plan functions and activities of the group of employers participating in the MEWA (which is typically handled by the PEO), and because the employers typically do not have a commonality of interest.

While the ERISA plan typically exists at the employer level (i.e., the plan sponsor is typically the client employer), the PEO and the employer generally enter into a contract in which the PEO agrees to handle any ERISA obligations that may exist. That being said, if the PEO fails to satisfy the ERISA obligations on behalf of the client employer, or the PEO has not specifically agreed to perform those obligations, the liability will ultimately remain with the client employer in the view of the relevant government agencies.

[5] See the discussion of this issue in the "Employer Shared Responsibility Penalties/ACA Reporting" section.
[6] US Department of Labor, Employee Benefits Security Administration, MEWAs Multiple Employer Welfare Arrangements under the Employee Retirement Income Security Act (ERISA): A Guide to Federal and State Regulation, p. 23 (April 2022).
[7] US Department of Labor, Employee Benefits Security Administration, MEWAs Multiple Employer Welfare Arrangements under the Employee Retirement Income Security Act (ERISA): A Guide to Federal and State Regulation, p. 23 (April 2022).
[8] Form M-1 must be filed within 30 days prior to operating in any state, annually by March 1 following each calendar year during which the MEWA was operating in any state(s), and within 30 days after certain other events, such as the addition of new contributing entities.
[9] A Form 5500 is generally required for a welfare benefit plan that covers at least 100 participants at the beginning of a plan year. A Form 5500 is required for a MEWA that provides health care if there is less than 25% common ownership among participating employers, even if there are fewer than 100 participants. Certain exceptions exist for smaller unfunded and fully insured plans if plan sponsorship is at the employer, rather than the MEWA, level.
[10] DOL Advisory Opinion 2019-01A (July 8, 2019)

SECTION 125

Typically, the PEO sponsors the Section 125 plan through which the PEO workers make pre-tax payroll deductions for their contributions to health and welfare benefits offered by the PEO. When that occurs, potential tax and compliance issues exist in the event the PEO workers are the common law employees of the client employer. This is because Section 125 generally provides that only an employer's common law employees may participate in the employer's Section 125 plan, and it is possible that the PEO workers would not be considered the common law employees of the PEO but of the client employer, which could disallow PEO workers to contribute to the PEO health plan on a pre-tax basis under IRC Section 125.

The tax and compliance issues raised when the PEO workers participate in a Section 125 plan sponsored by the PEO will primarily be the PEO's concern. Still, the PEO might seek to shift some responsibility or liability to the client employer through the PEO contract. Employers using a PEO should have the PEO contract reviewed by qualified legal counsel.

COBRA

In the situation where the PEO workers are provided health coverage under a plan sponsored by the PEO, the PEO's plan will often be a MEWA as discussed above. In that case, each client employer with employees participating in the PEO's plan will often be deemed to be sponsoring its own group health plan for purposes of ERISA and COBRA (as discussed above).

Under COBRA, most COBRA obligations (e.g., obligations to distribute various COBRA-related notices) fall on the plan administrator. ERISA defines the plan administrator as the person specifically designated as the plan administrator by the terms of the plan document or if an administrator is not so designated, the plan sponsor.[11] It is possible the PEO's plan will designate the PEO as the plan administrator, in which case the PEO will have the responsibility under COBRA to distribute various notices. The client employer would likely have COBRA responsibilities only if the PEO has not been designated as the plan administrator. Client employers should review their COBRA obligations under the PEO arrangement with qualified legal counsel.

[11] *ERISA §3.*

ISSUES FOLLOWING TERMINATION OF THE PEO CONTRACT

Employer Shared Responsibility Penalty Issues. Terminating a contract with a PEO can create issues regarding ESRP liability, depending on the circumstances.

- If the client employer was already an ALE and was the common law employer of the PEO workers, the client employer would be at risk of ESRPs as of the date on which the PEO ceases offering health coverage to the PEO workers on behalf of the client employer unless the client employer immediately begins offering affordable, minimum value medical coverage to the full-time employees who were previously PEO workers as of that date.
- If the client employer was already an ALE but was not the common law employer of the PEO workers, the PEO workers it hires should be treated like any other new employees for purposes of ESRPs. In general, an ALE must offer MEC to a new full-time employee no later than the first day of the fourth full calendar month of employment in order to minimize the risk of ESRPs.
- If the client employer was not an ALE and it was considered the common law employer of the PEO workers, termination of the PEO contract likely will not impact the client employer's status as an ALE (unless it hires other employees coincident with terminating the PEO contract, thereby increasing its number of common law employees).
- If the client employer was not an ALE and was not the common law employer of the PEO workers, hiring the PEO workers may impact the client employer's ALE status for the following calendar year. ALE status for a particular calendar year is generally based on the number of full-time and full-time equivalent common law employees the client employer employed in the prior calendar year. If a client employer finds it became an ALE for a particular calendar year after employing the PEO workers, the new ALE may find limited relief from ESRP liability during a limited non-assessment period. This is provided under the IRS rules generally applicable during the first three months of the first year for which an employer newly becomes an ALE (meaning the new ALE will not be penalized for failing to offer affordable and minimum-value coverage to its full-time employees during the first three months of the calendar year).

COBRA Issues. Terminating a contract with a PEO raises issues regarding whether the PEO workers have a right to COBRA continuation coverage and, if so, who must provide that coverage.

- If the PEO was the common law employer of the PEO workers, and the termination of the PEO contract causes both a termination of employment and a loss of coverage to a PEO worker enrolled in the PEO's group health plan(s), the PEO workers will have COBRA continuation rights under the PEO's group health plans.
- If the client employer was the common law employer of the PEO workers, the termination of the PEO contract will not automatically result in a termination of employment since those PEO workers may remain employed by the client employer. As a result, the PEO worker likely will not experience a COBRA qualifying event (e.g., termination of employment) even if the PEO worker is unable to continue coverage under the PEO's group health plan(s). A COBRA qualifying event occurs only if one of the triggering events listed in COBRA (e.g., termination of employment or reduction in hours) causes a loss of coverage under the terms of the group health plan. In this case, there is technically no termination of employment if the employee remains employed by the client employer, who was considered the common law employer of these PEO workers.
- If the client employer was the common law employer, it terminates a PEO worker's employment coincident with terminating the PEO contract, and the PEO worker loses coverage under the PEO's group health plan(s) as a result, then the PEO worker likely will experience a COBRA qualifying event. Who is responsible for providing the COBRA continuation coverage will depend on whether the PEO's group health plans are a MEWA and, if so, whether that MEWA constitutes an ERISA employee benefit plan or whether each client employer is deemed to sponsor its own ERISA plan.[12] In the former situation, the PEO's group health plan likely will have an obligation to provide the COBRA coverage. In the latter situation, a group health plan sponsored by the client employer likely will have an obligation to provide the COBRA coverage.

Application of COBRA to a PEO-sponsored health plan when an employer withdraws from a MEWA is unclear. Client employers should review their COBRA obligations in these situations with qualified legal counsel.

[12] This issue also exists with respect to any COBRA qualified beneficiaries receiving COBRA coverage at the time of termination of the PEO contract to the extent they had coverage under the PEO's plan due to employment by the client employer.

Issues Related to Section 125 Elections. Assuming the PEO workers are participating in a Section 125 plan sponsored by the PEO, termination of the PEO agreement will likely result in a termination of the PEO workers' participation in the PEO's Section 125 plan for any PEO workers that do not remain employed by the PEO.[13] To the extent the PEO workers were participating in any flexible spending accounts (e.g., health FSA), such termination may cause forfeiture of account balances (subject to any potential COBRA continuation rights that may exist under a health FSA).

To address the potential forfeitures, the client employer might consider adopting a Section 125 plan for the PEO workers that mirrors the PEO's plan, which is similar to the way a buyer could potentially mirror a seller's health FSA as part of an asset acquisition as further described in this paragraph. In Revenue Ruling 2002-32, the IRS provided some options related to FSAs[14] in an asset purchase transaction. One such option is for the buyer to cover the seller's employees, who are transferred to the buyer as part of the transaction under an FSA sponsored by the buyer. Under the health FSA sponsored by the buyer, "the transferred employees will have the same level of coverage provided under [the seller's] health FSA and will be treated as if their participation had been continuous from the beginning of [seller's] plan year. The transferred employees' existing salary reduction elections will be considered for the remainder of [buyer's] plan year as if made under [buyer's] health FSA." Whether this IRS guidance would be applicable in the context of a termination of a PEO contract is unclear, and the client employer would want to get specific legal advice from its own counsel regarding the viability of this approach.

ACA Reporting Obligations. As addressed above, if the PEO workers are the common law employees of the client employer while the PEO contract is effective, then the ACA reporting obligations fall on the client employer (i.e., Forms 1094/1095-C should be prepared in the client employer's name using its EIN). In this situation, the party legally responsible for the ACA reporting obligations will not be affected by the termination of the PEO contract (although, in practice, there may be a change if the PEO was preparing the forms on behalf of the client employer under the client employer's name and EIN).

However, if the PEO workers have been the common law employees of the PEO and then become the common law employees of the client employer upon termination of the PEO contract, the client employer will become responsible for the ACA reporting obligations with respect to those employees as of the date they are hired.

[13] *Ultimately, the terms of the PEO's Section 125 plan will control when participation ceases.*
[14] *The Revenue Ruling specifically refers only to health FSAs.*

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