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Employee Benefits for the Contingent Workforce

by

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Employee Benefits for the Contingent Workforce

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Employee Benefits for the Contingent Workforce*, No. 399-3rd, addresses the employee benefits-related questions and issues that arise in connection with the employment of contingent or alternative workers. These workers include independent contractors, leased employees, freelancers, on-call employees, contract and temporary employees, and part-time, seasonal and temporary employees, among others, that are employed under a myriad of employment arrangements that have come to characterize the "contingent workforce." Such arrangements include traditional staffing/outsourcing, payrolling, master vendor arrangements, employee leasing, and the use of professional employer organizations (PEOs). The Portfolio describes the fundamentals of worker classification principally under the I.R.C. and the Employee Retirement Income Security Act of 1974 (ERISA), and it examines the tax and benefits consequences of worker misclassification in a variety of traditional and non-traditional employment settings such as partnerships, LLCs, joint ventures, and multiple employer arrangements. Considered in detail are the issues that arise when contingent workers are improperly covered under, or excluded from, qualified and nonqualified retirement plans, welfare plans, certain fringe benefit plans, and stock-based compensation arrangements. Also covered are questions of fiduciary exposure for the proper classification of workers under ERISA-covered pension and welfare plans, and the consequences of the Patient Protection and Affordable Care Act of 2010 (ACA).

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A. Introduction

1. The Emergence of the Contingent Workforce

The past few decades have witnessed a seismic shift in the manner in which the American workplace is organized. Globalization, telecommunications and e-commerce have transformed the employment landscape. The employer-employee relationships that have their origins in the industrial revolution have long since given way to newer, more flexible ways of organizing the workplace. In place of command-and-control arrangements, which are stratified, hierarchical and life-long, employment practices have emerged that are shorter-term, network-based and less formal.[1] Where once employers employed almost exclusively workers who were legally defined and regulated as "common law" employees, they now are just as likely to hire "contingent" workers, the definition and regulation of whom is less clear.

The manner in which this "contingent" workforce should be regulated is part of a much larger debate that at its core questions the fundamental manner in which work is conducted and the workplace is organized. The regulatory scheme that was designed some time ago to distinguish between employer and independent contractor, for example, is now ill suited to striking a balance between the demands of global business and the legitimate rights and needs of workers. Current rules are straining under the weight of a load that they were never designed to bear, and meaningful change depends on reconciling the views of competing constituencies that, at the moment at least, appear irreconcilable. So for now, employers and workers are subject to a set of rules that, if violated, can often result in uneven and severe sanctions and costs, and even when adhered to diligently and in good faith provide few protections or guaranties.

That the regulation of contingent workers is inextricably bound to the regulation of the U.S. social welfare system further complicates the analysis. In marked contrast to most other developed countries, pension coverage, savings programs, health care, and skills training and enhancement in the United States are in large part employment-based. Although there are other variables affecting the equation, to the extent benefits are denied to contingent workers, they become the responsibility of the social welfare system. Those in favor of easing the regulatory burdens so as to facilitate the use of contingent workers claim that such efforts are essential to the competitiveness of U.S. employers, and that the failure to do so will cause employers to raise prices, reduce other benefits, or relocate their facilities overseas. Proponents of more stringent regulation disagree claiming that we ignore the larger social issues at our peril.[2]

The rise of mobile technology has enabled of a new breed of contingent worker who inhabits the "gig economy" or "on demand" economy. Characterized by alternative jobs that are usually temporary and influenced by technology, on-demand workers are for the most part independent contractors or freelancers. While the precise size of the gig economy is unknown, at least one poll places the number of on demand workers at nearly 1/3 of all U.S. workers — over 90 million individuals.[3] This number is anticipate to rise to 40% of U.S. workers by 2020.[4]

Because on demand workers are usually classified as independent contractors, employers are freed from such things as paying and remitting payroll taxes and worker's compensation and exposure to excise taxes for failing to offer health coverage, among other things. This business model is under attack. Lawsuits challenging the classification of on-demand workers as independent contractors, principally for state law purposes, have begun to work their way through the courts. At the same time, state legislatures and other governmental subdivisions have endeavored to limit the on demand economy through legislation and ordinances. These efforts all raise the same issues and questions, i.e., are gig workers independent contractors or employees? As judged by which standard? And if they are employees, whose employees are they?

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[1] *See, e.g.*, Tom Peters, *Reinventing Work: The Brand You* 50 (1999) (noting the breakdown of traditional, hierarchical work arrangements). "The fundamental unit of the new economy is not the corporation but the individual. Tasks aren't assigned and controlled through a stable chain of management but rather are carried out autonomously by independent contractors. These electronically connected freelancers — e-lancers — join together in fluid and temporary networks to produce and sell goods and services. When the job is done, the network dissolves and its members become independent agents again, circulating through the economy, seeking the next assignment." *Id.* at p. vii.

[2] Jonathan P. Hiatt & Lynn Rhinehart, *The Growing Contingent Work Force: A Challenge for the Future*, 10 Lab. Law. 143, 150 (1994) ("U.S. Industry will never succeed if it attempts to gain a competitive edge on the basis of worker wages, because other less-developed countries with fewer worker protection standards will always have lower wages as compared to the United States. Competing on the basis of wages alone will simply drive down the standard of living in the United States and further weaken the economy.").

[3] Katy Steinmetz, *See How Big the Gig Economy Really Is*, Time, Jan. 6, 2016.

[4] *Regulating the Gig Economy*, The World Bank, Dec. 22, 2015, http://www.worldbank.org/en/news/feature/2015/12/22/regulating-the-gig-economy.

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2. Scope

The employment of contingent workers is governed under a series of federal and state laws that mandate certain benefits and basic protections,[5] prohibit discrimination,[6] encourage offers of affordable group health insurance,[7] protect worker privacy,[8] impose constraints on the conduct of collective bargaining,[9] and even protect whistleblowers.[10] But the early skirmishes and high-profile cases that have informed the debate over the regulation of the contingent workforce have principally involved the I.R.C. and ERISA.[11] This Portfolio concerns itself with, and is for the most part limited to, a discussion of the impact of these laws on the employment of contingent workers and the management of the contingent workforce.[12]

B. Overview of Worker Classification

The legal status of a worker generally depends on making a threshold determination of whether the worker is an employee or an independent contractor.[13] If the worker is determined to be an employee, then the next layer of inquiry asks about the identity of the employer. In each case, the rights accorded to the worker, and the corresponding obligations imposed on the recipient of the worker's services, will flow from a determination of the worker's status under applicable law.[14] To further complicate matters, the definition of employee differs from statute-to-statute, and some statutes recognize more than one employer (i.e., shared or joint employees) while others do not. For example, a staffing firm may be the employer for employment tax purposes but not for benefit purposes and the staffing firm may be a co-employer for FLSA purposes.[15] Worker misclassification results where any of these inquiries are mishandled.

When attempting to classify a worker, there are few if any bright-line tests. For the most part, determining whether a worker is an employee or independent contractor, or identifying the employer for tax and benefits purposes, is subjective. The determination often involves the analysis of a number of factors that are weighted differently based on the unique circumstances of each case. Where contingent workers are concerned, the problems are further compounded. Labels such as "freelancer" and "leased employee" do not neatly correspond to the legal categories under which employment relationships are

[5] The Fair Labor Standards Act of 1938, Pub. L. No. 75-718, 29 U.S.C. §201–§219 (requiring employers to pay minimum wage to covered, non-exempt employees) (FLSA); the Family and Medical Leave Act of 1993, Pub. L. No. 103-3, 29 U.S.C. §2601–§2654 (requiring employers to allow employees reasonable medical leave) (FMLA); the Occupational Safety and Health Act of 1970, Pub. L. No. 91-596, 29 U.S.C. §651–§678 (requiring employers to provide safe workplace and comply with specific administrative safety and health standards) (OSHA); the Worker Adjustment and Retraining Notification Act, Pub. L. No. 100-379, 29 U.S.C. §2101–§2109 (requiring employers to give up to 60 days' notice to certain employees of plant closing or mass layoff) (WARN Act); the Migrant and Seasonal Agricultural Worker Protection Act, Pub. L. No. 97-470, 29 U.S.C. §1801–§1872 (protecting seasonal and temporary agriculture workers) (MSPA); the Consumer Credit Protection Act, Pub. L. No. 90-321, tit. III, 15 U.S.C. §1671–§1677 (protecting employees from discharge because wages garnished for indebtedness) (CCPA). There are also laws that govern contract labor such as the Davis-Bacon Act, Pub. L. No. 74-403, ch. 411, and Pub. L. No. 107-217 (recodification), 40 U.S.C. §3141 (mandating wages of laborers and mechanics employed at public building or public work site under certain contracts with the United States); the Contract Work Hours and Safety Standards Act, tit. I, Pub. L. No. 87-581 and Pub. L. No. 107-217 (recodification), 40 U.S.C. §3701–§3708 (offering additional wage and safety protection to employees covered by Davis-Bacon Act) (CWHSSA); the Copeland "Anti-Kickback" Act, Pub. L. No. 103-322, 18 U.S.C. §874 (protecting employees of contractors and subcontractors that enter into federally assisted construction contracts); and the Walsh-Healey Act, Pub. L. No. 74-846, ch. 88, and Pub. L. No. 111-350, 41 U.S.C. §6501–§6511 (giving similar protection as Davis-Bacon Act and CWHSSA to contract exceeding $10,000).

[6] Title VII of the Civil Rights Act, Pub. L. No. 88-352, 42 U.S.C. §2000e–§2000e-17 (basic employment-related protections for employees and job applicants against discrimination on the basis of race, color, religion, sex or national origin); the Equal Pay Act of 1963, Pub. L. No. 88-38, 29 U.S.C. §206 (prohibits wage-based discrimination on the basis of sex); the Americans with Disabilities Act of 1990 (ADA), Pub. L. No. 101-336, 42 U.S.C. §12101–§12213 (prohibits discrimination against individuals with disabilities); the Rehabilitation Act of 1973, Pub. L. No. 93-112 and Pub. L. No. 105-220, 29 U.S.C. §701–§796l (also prohibits discrimination based on disability, but limited to federal employees and private employers with federal contracts); the Age Discrimination in Employment Act of 1967 (ADEA), Pub. L. No. 90-202, 29 U.S.C. §621–§634 (prohibits discrimination on the basis of age); the Vietnam Era Veterans' Readjustment Assistance Act of 1972, Pub. L. No. 92-540, 38 U.S.C. §4211–§4215 (requires certain federal contractors to undertake affirmative steps to hire certain disabled veterans); the Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. No. 103-353, 38 U.S.C. §4301–§4335 (prohibits employers from discriminating against employees in the armed services); and the Immigration Reform and Control Act of 1986, Pub. L. No. 99-603, 8 U.S.C. §1324b (prohibits discrimination on the basis of national origin or citizenship status, among others). The Lilly Ledbetter Fair Pay Act of 2009, Pub. L. No. 111-2, amended Title VII, the ADEA, the ADA and the Rehabilitation Act of 1973 regarding the time frame in which victims of discrimination may challenge and recover for discriminatory compensation decisions or other discriminatory practices affecting compensation.

[7] The Patient Protection and Affordable Care Act, Pub. L. No. 111-148, as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, the Department of Defense and Full-Year Continuing Appropriations Act, 2011, Pub. L. No. 112-10 (collectively, the ACA). Section 1001 of the ACA added Public Health Service Act (PHSA) §2711–§2719A. Section 1563(f) of the ACA (as amended by ACA §10107(b)) added I.R.C. §9815(a) and Employee Retirement Income Security Act (ERISA) §715(a) to incorporate the provisions of part A of title XXVII of the PHSA into the I.R.C. and ERISA, and to make them applicable to group health plans and health insurance issuers providing health insurance coverage in connection with group health plans. All section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, unless otherwise specified.

[8] The Employee Polygraph Protection Act of 1988, Pub. L. No. 100-347, 29 U.S.C. §2001–§2009.

[9] The National Labor Relations Act (NLRA), Pub. L. No. 74-198, 29 U.S.C. §151–§169.

[10] Whistleblower Protection Act of 1989, Pub. L. No. 101-12.

[11] Pub. L. No. 93-406, 29 U.S.C. §1001–§1461.

[12] For a discussion of the full panoply of laws affecting the contingent workforce, see Michael Horne, Thomas Williamson, & Anthony Herman, Contingent Workforce: Business and Legal Strategies (2000). Some of the more important laws that may apply to a contingent worker depending on the worker's classification include: workers compensation laws; employment tax withholding laws; and minimum wage and overtime laws.

[13] *Cf.* I.R.C. §3121(d)(3) (treating certain individuals who are not common law employees as such for employment tax purposes). These so-called "statutory employees" are described in II.B. All section references herein are to the I.R.C. and the regulations thereunder, unless otherwise stated.

[14] *See* II.A. As a general rule, a statute's definition of "employee" will comport with the statute's larger purposes. Remedial statutes such as the FLSA have a more expansive definition of employee, while others, such as the I.R.C. and ACA, do not.

[15] 29 U.S.C. §203(e)(1) (defining the term "employee" as "any individual employed by an employer"). Section 203(g) of 29 U.S.C. defines the term "employ" to mean and include "to suffer or permit to work." The U.S. Supreme Court declared that the purposes of the FMLA require that the term "employee" should be read broadly, and it looked to the economic dependence of the worker as a key indicator of employment status. This test has come to be known as the "economic realities test." *See, e.g.*, *United States v. Silk*, 331 U.S. 704, 712 (1947) (holding that a strict interpretation would "invite adroit schemes by some employers to avoid the [Social Security] legislation"). For further discussion on the economic realities test, see II.A.3.

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regulated. A "freelancer" may be a common law employee, an independent contractor, or the common law employee of a third party, depending on the facts and circumstances.

Though the problem still persists, worker misclassification issues are no longer confined to distinguishing between an employee and an independent contractor. The rapid growth of employee staffing companies and professional employer organizations (PEOs) has led to a host of new issues. In these situations, employee status is assumed and the inquiry has shifted to the identity of the employer. Is it the staffing company or PEO, the recipient of the services, or perhaps both (or maybe even someone else)? The answer to this question has substantial tax and benefits consequences. In 2016, the Internal Revenue Service (IRS) began accepting applications for PEO certification. A certified PEO (CPEO) is recognized as being the employer of workers who could be the common law employee of others for employment taxes only. As such, the CPEO will be solely liable for employment taxes.[16]

C. Contingent Workers and Alternative Employment Arrangements

Economist Audrey Freedman is widely credited with coining the phrase "contingent employment" in a 1985 conference on employment security[17] to refer to conditionality of employment. Since then, the terms "contingent worker" and "contingent employment" have been used generically to describe employees in non-traditional employment relationships and the arrangements under which they are employed, respectively. In popular parlance, these terms are often used interchangeably with terms such as "alternative workers" and "alternative employment arrangements," or "flexible staffing arrangements."

The Contingent Workforce Supplement to the Current Population Survey compiled by the U.S. Department of Labor Bureau of Labor Statistics (BLS) describes contingent workers as those individuals who do not perceive themselves as having an explicit or implicit contract for ongoing employment and it gives as examples of the arrangements covering such individuals part-time work, self-employment, employment in the business services industry, and, in fact, almost any work arrangement that might be considered to differ from the commonly perceived norm of a full-time wage and salary job.[18] In addition to defining the term "contingent worker," the BLS Survey also describes a series of alternative employment arrangements that include independent contractors, on-call workers and day laborers, workers who are paid by temporary help or staffing agencies, and workers provided by contract firms.[19]

Many commentators (but not the BLS) use the term "alternative worker" in place of contingent worker to generically describe the contingent worker phenomenon, but few commentators adhere rigorously to the distinction between a contingent worker and his or her work in an alternative employment arrangement. Still others speak of non-traditional employment. In the case of the staffing industry, workers placed with client organizations are usually referred to as contract and temporary workers. PEOs, in contrast, refer to employees working at client organizations as co-employees, although this use is misleading when dealing with most tax and benefits issues.[20] The IRS adopted the terms "client organization" to describe the entity contracting with the PEO for workers and "worksite employees" to denote individuals working at client sites.[21] Because most of the terms used in these discussions have no independent legal significance, the substitution of one for another is largely a matter of preference. For purposes of this Portfolio, the phrase "contingent worker" is used rather than alternative worker, and the phrases "contingent employment arrangement" and "alternative employment arrangement" are used interchangeably. While other terms or phrases may more accurately capture the phenomenon, the terms "contingent worker" and "contingent workforce" appear to have become both well established and widely accepted.

A 1988 study commissioned by the Department of Labor distinguishes contingency work from traditional notions of employment based on the following three overarching criteria:

- *Time* — something different from an eight-hour, five-day workweek;
- *Permanency* — something other than a permanent relationship between an employer and the worker; and
- *Social Contract* — something different from the traditional reciprocal rights, protections, and obligations between the worker and the employer.[22]

This definition was cited with approval in a Department of Labor Advisory Council report issued in November 1999.[23] One of the Advisory Council witnesses, Dr. Edith Rasell, advanced an alternative definition in her testimony. She suggested that the term "contingent workforce" be abandoned in favor of the term "nonstandard workforce," which would include: (i) those workers who have no employer (i.e., independent contractors and self-employed individuals); (ii) those workers who

[16] §3511, added by The Tax Increase Prevention Act of 2014, Pub. L. No. 113-295. The PEO is treated as the successor employer for purposes of §3121(a)(1), §3231(e)(2)(C), and §3306(b)(1) (generally defining wages for employment purposes) and its unrelated customer is treated as the predecessor employer during the term of a service contract. §3511(b). For further discussion of the voluntary certification program for becoming a CPEO, see 392 T.M., *Withholding, Social Security, and Unemployment Taxes on Compensation.*

[17] Audrey Freedman, *'Contingent' Work-Force Expands Rapidly as Firms Seek Buffers in Economic Downturns*, 1985 Daily Lab. Rep. 138: A-3 (1985). *See also* Audrey Freedman, *The New Look in Wage Policy and Employee Relations*, Conference Board Report No. 865, New York (1985).

[18] Department of Labor, *Bureau of Labor Statistics, Contingent and Alternative Employment Arrangements, Report 900* (DOL News Release 95-318, Aug. 17, 1995) (1995 BLS Survey), http://www.bls.gov/news.release/history/conemp_082595.txt. The BLS Survey was first fielded in 1995 and revised in 1997, 1999, 2001, and 2005. For links to the revised studies see the BLS Web site at http://www.bls.gov/schedule/archives/all_nr.htm#CONEMP.

[19] Department of Labor, Bureau of Labor Statistics, *Contingent and Alternative Employment Arrangements* (Feb. 2005) (DOL News Release 05-1433, July 27, 2005) (2005 BLS Survey), http://www.bls.gov/news.release/conemp.nr0.htm.

[20] *See* IV.B.3. (contrasting the standards for classifying employees for tax and benefits purposes with those that apply for employment purposes and for the regulation of employee benefits plans, programs and arrangements).

[21] *See* Rev. Proc. 2002-21.

[22] United States Women's Bureau, U.S. Dept. of Labor, Flexible Workstyles: A Look at Contingent Labor: Conference Summary (1988).

[23] United States Department of Labor Advisory Council on Employee Welfare and Pension Plans, Report of the Working Group on the Benefit Implications of the Contingent Workforce (Nov. 10, 1999) (DOL Advisory Council Report), https://www.dol.gov/ebsa/adcoun/contrpt.htm.

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are at least nominally employed by one firm but work for another (e.g., contract workers provided by a staffing firm); (iii) workers whose work is short-term, temporary or unstable (i.e., temporary and on-call workers); and (iv) part-time workers.[24] This definition is extremely broad. It would even include, for example, employees hired through a PEO even if their employment is traditional in all other respects. One proposal aimed at developing a comprehensive definition of contingent employment focused on two key criteria: a low degree of job security and variability in hours worked.[25]

In 1993, President Clinton appointed former Secretary of Labor, John Dunlop, to chair a blue ribbon commission to study the U.S. labor markets and to submit policy recommendations.[26] Contingent work was one of the commission's areas of concern. The commission understood contingent work to mean the use of independent contractors, part-time, seasonal and temporary employees, and leased workers. The commission characterized the shift to contingent work as both a healthy development and a cause for concern, and in so doing it identified many of the seminal positions currently taken by the opposing constituencies in the debate over the regulation of the contingent workforce. On the positive side, it characterized contingent work as a sensible response to the demands of the global marketplace; but it also faulted existing tax, labor and employment laws that encourage the use of contingent relationships in order to evade legal obligations.[27]

Other definitions are more functional. A study by the Employee Benefits Research Institute, for example, defines contingent employment to include flexible employment practices such as temporary work, employee leasing, self-employment, contracting, and home-based work, as well as part-time work.[28] Further complicating the matter, the temporary services and staffing industries have developed their own vocabulary to describe contingent workers in a wide variety of industries and settings. The names and labels that make up this vocabulary do not often fit neatly into the patchwork of laws and regulations that govern employment relationships. Some commentators go so far as to allege that certain names and labels are intended to facilitate noncompliance with statutory and regulatory requirements.[29] What follows is a nonexhaustive list of the definitions, names and labels that have been attached to various contingent, alternative and flexible workforce arrangements. These categories are neither mutually exclusive, nor are they determinative of the underlying legal relationship of the parties.

1. Independent Contractors

All workers are subject to direction and control as to the outcome or particular result that the hiring party seeks to accomplish. Independent contractors differ from common law employees, however, in that they generally are not subject to direction and control as to the means whereby such result is to be accomplished. They usually perform tasks that require a high level of skill, discretion, and independent judgment. While the 1995 and 1997 BLS Studies distinguish between independent contractors who report that they are self-employed and those who consider themselves wage and salary workers, the BLS does not explain the basis for this distinction.[30] The receipt of wages or salary is usually indicative of, or at least an important factor in determining, common law employee status, and finding that a worker is a common law employee is inconsistent with finding that the worker is an independent contractor. The tests for determining whether a worker is an independent contractor differ depending on the statute being applied. For both tax and benefit purposes, the common law definition applies. Whatever the purpose, these tests have been subject to criticism from both employers and workers but for different reasons.

2. Leased Employees

Leased workers typically are hired by a third-party leasing firm and placed with a client. The leasing company usually maintains employment records and handles payroll. Many leasing companies will provide ongoing technical training and some will even furnish employee benefits. The term "leased employee" has engendered much confusion as it can be used in at least two different ways. First, it can denote any arrangement under which a worker is hired by a leasing agency and placed with an employer. Second, it can refer to the technical definition of leased employee in §414(n). The former may or may not be the common law employee of the recipient employer; the latter is never a common law employee.[31]

3. On-Call Employees

The BLS defines on-call workers as individuals who are called to work only on an as-needed basis, such as substitute teachers and construction workers supplied by union hiring halls.[32]

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[24] DOL Advisory Council Report (summarizing the testimony of Edith Rasell, Economist, Economic Policy Institute).

[25] Polivka & Nardone, *On the Definition of 'Contingent' Work*, Monthly Labor Rev. (Dec. 1989), at 9–16.

[26] Dunlop Commission, *Report and Recommendations of the Commission on the Future of Worker-Management Relations* (Dec. 1994). For a summary and critique of the commission's findings and recommendations, see Samuel Estreicher & Stewart Schwab, *Foundations of Labor and Employment Law*, 25–31 (2000).

[27] To combat abuses of the existing regulatory scheme, the commission recommended that Congress adopt a single definition of "employee" for all employment laws based on the "economic realities" test. Under that test, a worker would be treated as an employee if he or she is economically dependent on the employing entity. The economic realities test is described in II.A.3.

[28] Copeland, Fronstin, Ostow & Yakoboski, *Contingent Workers and Workers in Alternative Work Arrangements*, EBRI Issue Brief No. 207 (Mar. 1999), at 3.

[29] Jennifer Middleton, *Contingent Workers in a Changing Economy: Endure, Adapt, or Organize?* 22 N.Y.U. Rev. L. & Soc. Change 557, 583 (1996) (one of the primary motivations for employers to move to contingent work arrangements is to avoid employment regulations).

[30] Ken Hudson, *No Shortage of Nonstandard Jobs*, Economic Policy Institute (Sept. 1, 1999), at 8 (suggesting "wage and salary" independent contractors tend to be paid base salary plus commission, while "self-employed" independent contractors tend to be concentrated in higher status, professional occupations). However, the method of payment is only one of a number of factors under which employment status is determined. Although it is perhaps possible to envision a set of facts under which this would occur, the BLS does not attempt to explain how a worker that is paid a wage or salary might escape classification as a common law employee rather than an independent contractor. *Id.*

[31] *Wolf v. Coca-Cola Co.*, 200 F.3d 1337, 23 EBC 2497 (11th Cir. 2000) (plan properly excluded leased worker without regard to common law status where plan language did not refer to §414(n) but rather defined "leased employees" to mean "individuals who perform service for the company under an arrangement with a leasing organization.").

[32] 2005 BLS Survey at Technical Note.

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4. Temps/Agency Temporary Employees

The category of workers who are paid by temporary help agencies is defined by the BLS to mean individuals who work for temporary agencies and are assigned to work for other companies, such as temporary workers supplied to companies to fill in for full-time workers who are on vacation or to work on special projects.[33] A study by the Government Accountability Office further distinguishes and tracks direct hire temps.[34] These are individuals hired directly by companies to work for a specified period of time, for the same types of work as agency temporary employees.

5. Contract Staffing Firms

The category of workers provided by contract firms is defined by the BLS to mean individuals who work for companies that provide services to other firms under contract, such as security, landscaping, or computer programming services.[35]

6. Professional Employer Organizations (PEOs)

PEOs specialize in human resources management. They handle such tasks as payroll, tax filing, and human resource administration; they usually offer benefit packages; and some handle workers' compensation and unemployment compensation management and claims adjudication. While many PEOs simply take over the client's existing employees, others recruit, train and place employees in the workplace of the client. The DOL Advisory Council Report characterizes the growth of PEOs as explosive.[36] Although PEOs often claim to be co-employers with the client, there is little statutory or regulatory support for this view where tax and benefits issues are concerned. Statutory and regulatory guidance for PEOs take the approach of making the PEO the employer for employment tax purposes in the case of a CPEO and of making the client the employer in the case of qualified retirement plans.[37]

Comment: Employees of PEOs are not included in most definitions of contingent workers in large part because their employment has many characteristics of more traditional employment arrangements. Nonetheless, much of the debate over the regulation of the contingent workforce includes PEOs.

7. Outsourcing

Outsourcing is a generic term used to describe arrangements under which a third-party firm (such as a leasing company or a PEO) with a particular expertise contracts with a recipient not only to provide workers but also to assume responsibility for a discreet business function, such as security or food service.

8. Payrolling

Under a payrolling arrangement, a third-party firm handles the processing of payroll for a recipient. This includes issuing paychecks, calculating and remitting employment taxes and income tax withholding. In a payrolling arrangement, the third-party firm is usually nothing more than the agent of the employer for payroll processing purposes.

9. Freelancers

Like so many of the terms that have evolved to describe contingent workers, "freelancer" has no precise legal definition. It ordinarily refers to workers whose affiliation with an employer is less formal and structured than that of a traditional, common law employee. A freelancer may be either a common law employee or an independent contractor depending on the surrounding facts and circumstances. If the services of the freelancer are secured through a leasing company or PEO, the freelancer may be the common law employee of the leasing company, the common law employee of the service recipient, or an independent contractor (in which case the leasing company or PEO is nothing more than a middleman between the service provider and the service recipient).

10. Contract Employees and Technical Workers

These arrangements involve highly skilled workers who are placed on extended assignment. Depending on the particulars of the arrangement, these workers may be independent contractors, leased employees or common law employees.

11. Master Vendor Arrangements

Often, a single vendor will assume the responsibility for handing all of a recipient's leased employee requirements. Under such an arrangement, the vendor coordinates hiring, invoicing and reporting.

12. Perma-Temps

Perma-temps are employees who are arbitrarily classified as temporary by their employers even though they perform the same regular jobs and work for years side-by-side with other workers who are given the status of employees.

Comment: One of the witnesses who appeared before the DOL Advisory Council described perma-temps as "people who are given an improper label, but really work very long periods of time."[38] Such individuals are distinguished from real contingent workers (i.e., short-termers).[39] Thus, it would appear that, to be a perma-temp, the worker must be either intentionally or negligently misclassified *and* he or she must also perform services over an extended period of time. But if a worker is either intentionally or negligently misclassified, then the tenure of the relationship is irrelevant and the perma-temp label redundant.

[33] 2005 BLS Survey at Technical Note.

[34] *See* Government Accountability Office Report to the Ranking Minority Member, Committee on Health, Education, Labor, and Pensions, U.S. Senate, Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification (July 2006), http://www.gao.gov/new.items/d06656.pdf.

[35] 2005 BLS Survey.

[36] DOL Advisory Council Report, p. 19 (summarizing the testimony of Milan Yager, Executive Vice President, National Association of Professional Employer Organizations).

[37] *See* §3511 (describing the employment tax treatment of such workers by CPEOs) and Rev. Proc. 2002-21 (describing rules regarding qualified retirement plans for such workers). For further discussion of the voluntary CPEO program, see 392 T.M., *Withholding, Social Security, and Unemployment Taxes on Compensation.* For discussion of a DOL rule under which a PEO qualifies under Title I of ERISA as an employer that may sponsor a multiple employer (defined contribution) retirement plan for its employers' employees, see IV.B.9.

[38] The DOL Advisory Council Report, p. 23 (summary of the testimony of David F. Strobaugh, Esq., Benedict, Strobaugh & Strong).

[39] The DOL Advisory Council Report, p. 23.

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This invites the question — does the tenure of the relationship matter? While this witness implies that it does, this view is difficult to square with existing law. See the discussion in III.B.4. (relating to retroactive reclassification of workers).

13. Part-Time, Seasonal and Temporary Employees

These employment arrangements include workers scheduled to work regularly or intermittently on less than a full-time basis. These workers are usually common law employees. The challenge for employers is to determine the extent to which such employees must be covered under the employer's various employee and fringe benefit plans.

D. Measuring the Size and Scope of the Contingent Workforce

Reliable estimates of the size of the contingent workforce are notoriously hard to come by. The problem is not so much in designing the study under which the number is to be measured; rather, disputes arise over which workers to count and how to interpret the data. Competing constituencies argue for a measure that is best suited to their view of how the employment of contingent workers should be regulated. Responding to the contentiousness that these disputes engender, one commentator aptly observed that "[w]hen one mixes the law with contingent labor markets, one would be well advised to add a teaspoon of humility."[40]

There are now at least four different constituencies in the debate over worker classification, and each has a strikingly different view of how contingent workers should be treated. They include the following:

• *Business and Industry.* Representatives of business and industry typically argue for the adoption of laws that will facilitate the use of contingent workers. Proponents of this view claim that contingent employment arrangements are a necessary response to the demands of global business that has become hyper-competitive and that, in any case, the workers themselves value the freedom and flexibility that these arrangements offer. This view is subject to the criticism that it focuses on bottom-line results without taking into account the welfare of their workers.[41]

• *Labor Unions.* Labor unions and others sympathetic to their cause decry contingent employment arrangements, claiming that they result in the establishment of a permanent sub-class of employee who earns less, has little or no job security, and is rarely provided with important, non-cash welfare and pension benefits.[42] They further claim that large numbers of non-standard workers feel compelled to accept these arrangements for economic and personal reasons beyond their control and that nonstandard employment has the potential to become a mechanism for providing substandard wages. While there is evidence to support these claims, it is not clear whether these problems are susceptible to a legislative solution.[43]

• *Plaintiff's Class Action Bar.* The plaintiff's class action bar claims that employers classify workers as contingent in order to deprive them of benefits to which they are rightfully entitled as employees. But in the absence of any law requiring similar treatment of similarly situated employees, they leave themselves open to the criticism that they are using the judicial process to accomplish a result more appropriately achieved through legislation.

• *The Regulators.* While the regulators are supposed to implement laws passed by Congress in a neutral fashion, each regulatory agency inevitably sees the world through the prism of its own unique mission. The IRS, for example, will likely favor an interpretation that enhances its ability to collect revenues, while the U.S. Department of Labor (DOL) and the Equal Employment Opportunity Commission (the EEOC) are likely to support laws that protect workers. The Department of Commerce, on the other hand, can be counted on to side with business and industry. Where changes to the laws affecting the contingent workforce are concerned, each agency can be expected to act in a manner consistent with its mission and purpose. In the case of the amendments made to the PHSA by the ACA, the matter is further complicated since the Departments of Health and Human Services, Labor and Treasury share interpretive jurisdiction.

Compounding the confusion is that contingent employment arrangements can be driven either by supply (the worker's need for employment) or demand (the employer's need for workers). The plight of a contract worker with specialized software skills who likes to windsurf for six months at a time, and who enjoys her status as a freelancer as a result, is quite different from the migrant farm worker who would jump at the opportunity for a more stable working environment.

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[40] Richard S. Belous, *The Rise of the Contingent Workforce: The Key Challenges and Opportunities*, 52 Wash. & Lee L. Rev. 863, 864–66 (1995), (asserting that almost every employer's workforce contains both "core" workers and "contingent workers"). The core workers are those workers with a strong affiliation with the employer and a large stake in the organization. These individuals show long-term attachment to the company and have a measure of job stability. So long as these workers follow certain rules and meet certain norms and standards, their employer will provide long-term employment and some measure of advancement. The latter group (i.e., "contingent workers") has a weak affiliation with a specific employer, and they do not have a significant stake in the company. The prospects for advancement are slim and the job stability is noticeably absent. Much of the debate over the size of the contingent workforce centers on where one draws the line between these two cohorts. *Id. See also* Sandra E. Gleason, *The Shadow Workforce: Perspectives on Contingent Work in the United States, Japan, and Europe* (2006).

[41] *See, e.g.*, Edward A. Lenz, *The Staffing Services Industry Myth and Reality: Global Competition and the American Employment Landscape as We Enter the 21st Century*, Proceedings of New York University 52nd Annual Conference on Labor (Estreicher Ed., Klewer Law International 2000).

[42] Ken Hudson, *No Shortage of Nonstandard Jobs*, Economic Policy Institute (Sept. 1, 1999), at 1.

[43] Richard S. Belous, *The Rise of the Contingent Workforce: The Key Challenges and Opportunities*, 52 Wash. & Lee L. Rev. 863, 876 (1995). "One response to the rise of the contingent workforce has been to try to regulate it out of existence, or at least to reduce its size. However, even if the political will for such an action was there, which it is not, it would be difficult to do so unless the United States is willing to vastly boost the amount of resources devoted to regulating labor markets in order to combat the 'rational' choice to cheat when enforcement costs are low. Increased government regulation would also put many U.S. employers at a serious competitive disadvantage. Furthermore, given the increased mobility of capital and technology, it would increase the drive for many corporations to locate their facilities overseas. Thus, being against the rise of the contingent workforce is like being against the automobile, which has produced costs as well as benefits. Just as it is unlikely that the automobile will be diminished, the contingent workforce is not about to wither away."

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Those troubled by the growth of the contingent workforce are inevitably concerned with the lack of benefits and statutory protections afforded workers in these arrangements. The choice of definition determines the seriousness and trajectory of the problem. Each side attempts to debunk the other's myths about the contingent workforce,[44] and reliable studies from well-established institutions reach conflicting results. Both the 2000 GAO Study (discussed at I.D.4.) and the DOL Advisory Council Report (discussed at I.D.2.) place the number of contingent workers at approximately 30% of the American workforce, and they conclude that these workers have substantially less access to traditional employment-based health and retirement benefits. Both studies also predict serious adverse social implications if the growth of the contingent workforce continues unchecked. The 1999 EBRI Study reaches almost exactly the opposite conclusion on much of the same raw data. It concludes that the contingent workforce covers a far smaller percentage of workers, and that their numbers have remained relatively constant over time. Both studies rely heavily on statistical data furnished by the BLS.

1. BLS Data

Almost every statistical estimate of the size and scope of the contingent workforce begins with, or at least gives serious consideration to, data accumulated by the BLS. The BLS defines three successively broader definitions of contingent workers:

• *Estimate 1.* Wage and salary workers who expect their jobs will last for an additional year or less and who worked at their jobs for one year or less. Self-employed workers and independent contractors are excluded from the estimate. For temporary help and contract workers, contingency is based on the expected duration and tenure of their employment with the temporary help or contract firm, not with the specific client to whom they were assigned.

• *Estimate 2.* Workers, including the self-employed and independent contractors, who expect their employment to last for an additional year or less and who worked at their jobs (or were self-employed) for one year or less. For temporary help and contract workers, contingency is determined on the basis of the expected duration and tenure with the client to whom they are assigned, instead of their tenure with the temporary help or contract firm.

• *Estimate 3.* Workers who do not expect their jobs to last. Wage and salary workers are included even if they already held the job for more than one year and expect to hold the job for at least an additional year. The self-employed and independent contractors are included if they expect their employment to last for an additional year or less and they were self-employed or independent contractors for one year or less.

Under the broadest measure of contingency, there were 5.7 million contingent workers in February 2005, accounting for about 4% of total employment.

The following table sets out the numbers in each of the three categories of contingent workers from the BLS Surveys (numbers are millions of workers):

Survey	Total Contingent and Noncontingent Workers	Estimate 1	Estimate 2	Estimate 3
1995	123.2	2.7	3.4	6.0
1997	126.7	2.4	3.1	5.6
1999	131.5	2.4	3.0	5.6
2001	134.6	2.3	3.0	5.4
2005	138.9	2.5	3.2	5.7

The BLS also compiles statistics on four categories of "alternative employment arrangements" including independent contractors, on-call workers, temporary help agency workers, and workers provided by contract firms. Taken together, these employees represent approximately 10% of the workforce.[45] Set out below is a summary of the BLS data (the numbers are percentages of the U.S. workforce):

Survey	Independent Contractors	On-Call Workers	Temporary Help Agencies	Contract Firms
1995	6.7	1.7	1.0	0.5
1997	6.7	1.6	1.0	0.6
1999	6.3	1.5	0.9	0.6
2001	6.4	1.6	0.9	0.5
2005	7.4	1.8	0.9	0.6

2. Department of Labor Advisory Council

The DOL Advisory Council Report estimates the number of contingent workers to be about 42 million workers or 30% of the workforce.[46] In reaching this conclusion, the Council considered and ultimately rejected the BLS view as failing to describe and include those workers who were most likely to be deprived of health and pension coverage by reason of their contingent status.[47] The principal difference between the BLS es-

[44] *Compare* Jonathan P. Hiatt & Lynn Rhinehart, *The Growing Contingent Work Force: A Challenge for the Future*, 10 Lab. Law. 143, 143–59 (1994) (debunking myths concerning voluntary nature of contingent workforce, claims of pay equality and the ability of contingent workers to enhance the competitiveness of U.S. industry) *with* Edward A. Lenz, *The Staffing Services Industry: Myth and Reality: Global Competition and the American Employment Landscape — As We Enter the 21st Century*, New York University 52nd Annual Conference on Labor (Kluwer Law International, 2000) (debunking myths concerning rapid growth of contingent workforce, denying that contingent workers are second-tier "perma-temps" and insisting contingent workers are subject to many of same statutory protections as traditional employees).

[45] The 1995, 1997, 1999, 2001 and 2005 BLS Surveys place the total percentages of workers in all of these categories combined at 9.9%, 9.9%, 9.3%, 9.4% and 10.7% respectively.

[46] DOL Advisory Council Report on Employee Welfare and Pension Plans, Report of the Working Group on the Benefit Implications of the Contingent Workforce (Nov. 10, 1999), p. 2.

[47] DOL Advisory Council Report, p. 9 ("The term 'contingent workforce' utilized by the Bureau of Labor Statistics does not adequately describe the workforce at risk in the traditional employment-based system of health and re-

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timates and those adopted by the Advisory Council is that the latter includes regular, part-time workers in its count. This difference flows almost automatically from the definition of contingent worker adopted by the Advisory Council that placed in that category any worker who was employed in a nonpermanent employment arrangement or less than full-time.

Note: In designing its Contingent and Alternative Worker Supplement to the Current Population Survey, the BLS did not take into account variability of hours. The BLS also adopted a highly subjective measure, i.e., the worker's perception of his or her job security. As a result, part-time workers who are, or at least perceive themselves to be, in stable, long-term employment relationships, are not considered "contingent" workers for BLS purposes. This omission explains much of the divergence in the numerical estimates of the contingent workforce. Those studies that place the size of the contingent workforce at 25% to 30% of the total U.S. workforce routinely count part-time workers and independent contractors. According to BLS data, these cohorts comprise about 15% and 6% of the workforce, respectively.

The Advisory Council Report next examines the percentage of workers with pension and/or health coverage and concludes that contingent workers fare poorly when compared to regular, full-time workers.

Based on its findings, the Council issued a series of recommendations aimed at expanding the reach of collective bargaining to facilitate organization of independent contractors, temporary employees and contract employees, expanding the availability of multiple-employer welfare plans, and encouraging individualized retirement plans similar to tax-sheltered annuities under I.R.C. §403(b), among others.

3. 1999 EBRI Study

The 1999 EBRI Study generally accepts the BLS data at face value and concludes that many of the conventional notions concerning the rapid growth of the contingent workforce are incorrect.[48] The study also describes at length the tradeoffs for both employers and employees. While employers who hire contingent workers gain certain scheduling flexibility, as well as the ability to grow incrementally and manage labor costs, they forfeit commitment and some cost effectiveness particularly as these workers are less likely to have company-specific knowledge and continuity. Workers too gain flexibility under contingent work arrangements and they also get access to the workforce that brings with it the ability to gain valuable experience and a supplemental income. But they generally are paid less than traditional employees, and they sacrifice job security and benefits.

Perhaps the most useful contribution of the 1999 EBRI Study is that it concisely catalogs and summarizes the wage and benefit gap experience by many contingent workers when compared to their traditionally employed counterparts. Not surprisingly, this gap correlates to age, gender and family income. While there are substantial disagreements over the size and composition of the contingent workforce, this study documents clearly that contingent workers are less likely to have health insurance or pension coverage.

4. 2000 GAO Study

The 2000 GAO Study rejected the BLS data and methodology as being too narrowly focused. This study places the size of the contingent workforce at about 30% of the U.S. workforce. Not surprisingly, much of the difference can be explained by the inclusion of part-time workers. The study identifies and tracks the following:

Category	Number of Workers (in thousands)	Percentage of Total Workforce
Agency temps	1,188	0.9
Direct-hire temps	3,227	2.5
On-call workers and day laborers	2,180	1.7
Contract company workers	769	0.6
Independent contractors	8,247	6.3
Self-employed workers	6,280	4.8
Standard part-time workers	17,380	13.2
Subtotal	39,271	29.9
Standard full-time workers	92,222	70.1
Total Workforce	131,493	100.0

On the subject of the growth of the contingent workforce, the 2000 GAO Study notes that the contingent workforce, as measured by the BLS, remained static but it also cites the rapid growth in certain categories as a cause for concern. The study concludes that the contingent workers are more likely than traditional, full-time workers to have low incomes and are less likely to be covered by employee benefit plans. The study also deals at length with the laws that are designed to protect workers and the extent to which those protections are available to contingent workers.

5. 2007 GAO Study

A 2007 GAO study found that the number of independent contractors in the total employed workforce grew from 6.7% in 1995 to 7.4%, or 10.3 million workers, in 2005. Independent

tirement benefits."). In addition to data from the BLS, the Advisory Council Report examined findings by the Economic Policy Institute and Women's Research and Education Institute and the W.E. Upjohn Institute for Employee Research, which concluded that the contingent workforce is 28.6% and 31.2% of the American workforce, respectively. The discrepancy in the tallies can in large part be attributed to the manner in which part-time employees are counted. The Advisory Council Report also expressed concern over the growth of the temporary staffing industry that, although involving relatively small numbers of workers, appears to be growing at a substantial rate. *Id.* at 7–8.

[48] *Accord* Henry Farber, *Are Lifetime Jobs Disappearing?* Labor Statistics Measurement Issues, 158 (John Haltiwanger, et al., eds., 1998) (finding that no systematic change has occurred in the various measures of the overall distribution of job duration over the past two decades). However, "the overall figures mask two important, though perhaps unsurprising changes in the job duration of particular groups of workers. First, individuals, particularly men, with little education (less than 12 years) are less likely to be in jobs of long duration today than they were 30 years ago … . Second, women with at least a high school education are substantially more likely to be in long-term jobs than they were 20 years ago." *Id. See also* Steven Hipple, *Contingent Work in the Late-1990s*, Monthly Labor Rev. (Mar. 2001), at 3 (concluding that, despite the strong labor market, the incidence of contingent work changed little between 1997 and 1999).

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contractors, in 2005, were on average 46 years old, were almost twice as likely to be male than female, and almost two-thirds had some college or higher education.[49]

E. Coming Regulatory Challenges

While academic, government and industry studies ponder the size of the contingent workforce and the problems that it engenders, employers are left with a regulatory environment that presents daunting challenges to those who act in good faith, and more than a few opportunities for manipulation for those who do not. Here, anecdotal evidence may well be more valuable than laboriously collected data.[50] There is in many cases a disconnect between the concerns addressed by the various organizations and individuals that have studied the matter and the real world concerns of employers and workers. Consider the following:

• The Advisory Committee Report identifies PEOs as an area of "explosive" growth, but employees of PEOs were not included in its definition of contingent workers. PEOs in particular have gained increased acceptance in large part due to the complexity of the laws regulating the employment relationship. But while employees of PEOs are more likely to be covered by benefit plans, the tax and benefits implications of such arrangements are troubling because the status of workers as "co-employees" of the PEO and the recipient is not supported by either the I.R.C. or ERISA, which do not recognize this concept. (This issue is covered at length in IV.B.)

• Uncertainty over the rules for determining who is an independent contractor, and related concerns over employment tax and income tax withholding, has led many large corporations to retain workers through staffing firms that handle withholding obligations as the employer of record — without asking whether the worker is an employee or an independent contractor. Primarily as a result of this, the temporary staffing industry also has experienced enormous growth.

• Emerging issues relating to employees of LLCs and joint ventures raise a host of questions involving contingent worker issues, but, perhaps due to the relatively small numbers of workers affected, these questions have received scant regulatory attention.

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[49] *Testimony Before the Subcommittee on Income Security and Family Support and Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives, Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification.* General Accountability Office, May 2007 (http://www.gao.gov/assets/120/116524.html).

[50] Gillian Lester, *Careers and Contingency*, 51 Stan. L. Rev. 73, 9 (1998) (The article explores the traditional arguments advanced both for and against the growth of the contingent workforce and offers a "new Keynesian" approach that identifies the problem as the persistence or growth of a class of workers for whom there is a "mismatch" between the jobs they hold and their human capital, abilities, and desires. According to the author, "the BLS definitions may simply fail adequately to capture the size of the class of workers who suffer the type of labor market problems that reform advocates in the contingent employment debate seek to ameliorate."). *Id.*

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II. Employment Status — Common Law Employee vs. Independent Contractor

A. *Basic Concepts*

1. *Definition of Employee*

To properly assess the status of a contingent worker, first determine whether the worker is an employee or an independent contractor. If a worker is an employee, identify the employer. The precise manner in which this line of inquiry proceeds differs depending on the statute or rule being applied. In interpreting the many statutes that regulate and tax employment relationships, the courts have often adopted differing definitions of employee depending on the particular statute's purpose or intent. For benefits and tax purposes, the courts adopted a common law test that has its roots in agency law. Some statutes determine employee status based on an economic realities test that is generally broader in scope than the common law tests. Lastly, some courts have adopted a combination of the common law test and the economic realities test that has come to be known as the hybrid test.

The discussion of the employee vs. independent contractor that follows is intended to introduce the terms and concepts necessary for an understanding of worker classification issues.[51]

2. *Common Law Agency Test*

Employment status in common law was based on notions of agency in the context of the master/servant relationship. The master might be held liable for the actions of a servant acting within the scope of his or her employment but not for the same actions if performed by an independent contractor. The Restatement (Second) of Agency distinguishes between a servant and an independent contractor principally with reference to "the extent of control, which by the agreement, the master may exercise over the details of the work."[52] It then goes on to list the following additional factors:

- whether or not the worker is engaged in a distinct occupation or business;
- the kind of occupation, including reference to whether the work is usually done under the direction of the employer or by a specialist without supervision in the locality;
- the skill required in the particular occupation;
- whether the employer or the worker supplies the instrumentalities, tools, and the place for work for the person doing the work;
- the length of time for which the person is employed;
- the method of payment — i.e., by the hour or by the job;
- whether or not the work is part of the regular business of the employer;
- whether or not the parties believe they are creating the relation of master and servant; and
- whether the principal is in business.[53]

These factors are not intended to be exhaustive, and courts have felt free to expand on[54] or consolidate[55] them even while agreeing with and adopting the Restatement's basic approach. But these differences are largely cosmetic. The Restatement's principal focus centers on the right to control both (i) the *result* the worker is to accomplish and (ii) the *means* by which such result is to be accomplished. It is this dual right of control that is the hallmark of the common law agency test.

The U.S. Supreme Court has signaled its preference for the common law agency test over the economic realities test, at least in the context of employment discrimination, and possibly also in cases involving employment status.

In *Clackamas Gastroenterology Associates, P.C. v. Wells*,[56] a terminated employee brought an ADA action against a medical professional corporation. The corporation denied that it was covered by the ADA on the grounds that it did not have 15 or more employees as required by the statute. Applicability of the ADA hinged upon whether the four physician-shareholders who owned the corporation and constituted its board of directors should be counted as employees. Relying on the economic realities test adopted by the Seventh Circuit in *EEOC v. Dowd & Dowd, Ltd.*,[57] the district court concluded that the doctors were not employees for ADA purposes because they were more analogous to partners in a partnership than shareholders in a corporation. On appeal, however, noting that the Second Circuit in *Hyland v. New Haven Radiology Associates, P.C.*,[58] had rejected the economic realities approach, the Ninth Circuit reversed, observing professional corporations were attempting to have the "best of both possible worlds" by claiming corporate status for the tax and civil liability advantages while simultaneously claiming partnership status to avoid liability for employment discrimination.

Acknowledging that it was dealing with a new type of business entity that had no exact precedent in the common law, the U.S. Supreme Court was persuaded that the Equal Employment Opportunity Commission's (EEOC) approach, which focuses primarily on the common law element of control and utilizes a six-factor analysis (as set forth in the EEOC Compliance

[51] For a comprehensive discussion of this distinction, see 391 T.M., *Employment Status — Employee v. Independent Contractor.*

[52] Restatement (Second) of Agency, §220(2)(a) (1958).

[53] Restatement (Second) of Agency, §220(2)(b)–(j) (1958).

[54] *E.g.*, *Comm. for Creative Non-Violence v. Reid*, 490 U.S. 730, 751 (1989) (expanding the list of relevant factors to determine employee status). The *Reid* court added, "whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work." *Id.*

[55] *Alexander v. Rush N. Shore Med. Ctr.*, 101 F.3d 487, 492 (7th Cir. 1996) (constricting Restatements list of factors relevant to determine employee status), cert. denied, 522 U.S. 811 (1997). The elements of common law employee status include: "(1) the extent of the employer's control and supervision over the worker, including directions on scheduling and performance of the work, (2) the kind of occupation, type of occupation and nature of the skill required, including whether the skills are obtained in the workplace, (3) responsibility for the costs of operation, such as equipment, supplies, fees, licenses, workplace, and maintenance of operations, (4) method and form of payment and benefits, and (5) length of job commitment and/or expectations." *Id.*

[56] 538 U.S. 440 (2003).

[57] 736 F.2d 1177 (7th Cir. 1984).

[58] 794 F.2d 793 (2d Cir. 1986).

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Manual), should be followed. The Court remanded the case for further findings under the EEOC standard.

3. Economic Realities Test

The common law agency test is not the exclusive standard by which an employee is distinguished from an independent contractor. The principal alternative is the economic realities test. With the notable exception of ERISA, the economic realities test generally has been applied to statutes that are remedial in nature. These statutes include the Fair Labor Standards Act,[59] the Family and Medical Leave Act,[60] the Occupational Safety and Health Act of 1970,[61] and to a lesser extent, Title VII of the Civil Rights Act of 1964.[62] The economic realities test looks to the extent a worker is economically dependent on the employer rather than the degree of control exercised or exercisable by the employer. The greater the degree of dependence, the less likely a worker is self-employed. Whether a worker is an employee or independent contractor under this test typically depends on a series of factors. The following cases illustrate this approach:

• **Three-Factor Test** — *Caruso v. Peat, Marwick, Mitchell & Co.*[63] The court considered three primary factors: (1) the individual's control over the operation of the business, (2) whether the calculation of compensation was based on a percentage of profits, and (3) the individual's employment security.[64]

• **Four-Factor Test** — *Bonnette v. California Health & Welfare Agency*.[65] This case involved claims for back wages under the FLSA by workers who provided domestic, in-home services to disabled public assistance recipients. The defendant was a public social service agency that employed the workers. The workers were paid at rates lower than the federal minimum wage. In holding for the workers, the Ninth Circuit expressly rejected the common law definition of employer in favor of the economic realities test. Citing with approval the approach taken by the lower court, the Ninth Circuit applied the following factors: "whether the alleged employer (1) had the power to hire and fire the employees, (2) supervised and controlled the employee work schedules or conditions of employment, (3) determined the rate and method of payment, and (4) maintained employment records."[66]

• **Five-Factor Test** — *Herman v. Express Sixty-Minutes Delivery Servs., Inc.*[67] The Secretary of Labor brought suit against the employer to enjoin, among other things, alleged violations of the minimum wage requirements under the FLSA. The employer operated a delivery service in the Dallas-Fort Worth, Texas metropolitan area. Drivers recruited through newspaper advertisements and word of mouth made deliveries. The drivers signed independent contractor agreements; they provided their own transportation, gasoline, maintenance and insurance; they also furnished their own uniforms and supplies. While not required, uniforms were described as "preferred." Drivers could accept or reject assignments without fear of retaliation. In holding that the drivers were independent contractors, the Fifth Circuit applied the following five factors: (1) the degree of control exercised by the alleged employer, (2) the relative investment by the workers and the alleged employer, (3) the degree to which the employees' opportunity for profit and loss is determined by the alleged employer, (4) the skill and initiative required, and (5) the permanency of the relationship. Significantly, the court declined the invitation of the Secretary of Labor to consider other factors.[68]

• **Six-Factor Test** — *Baker v. Flint Eng'g & Constr. Co.*[69] Flint Engineering engaged in the installation and servicing of oil and gas pipelines in New Mexico. When Flint was awarded a winning bid, it hired a variety of workers including skilled rig welders. The welders were hired as independent contractors. Each invested in and owned a specially equipped truck or "welding rig." The welders worked under the supervision of Flint foremen on a schedule set by Flint in order to coordinate their efforts with other workers on the job site. A group of welders brought suit under the FMLA claiming that they were employees rather than independent contractors. The District Court found that the welders were employees and not independent contractors. In upholding the decision of the lower court, the Tenth Circuit applied the economic realities test using the following, six factors: (1) the degree of control exerted by the alleged employer, (2) the worker's opportunity for profit or loss, (3) the worker's investment in the business, (4) the permanence of the working relationship, (5) the degree of skill required to perform the work, and (6) the extent to which the work is an integral part of the alleged employer's business.[70]

Note: Informal guidance issued by the DOL's Wage and Hour Division (WHD), which was withdrawn effective June 7, 2017, indicated how staff should approach the Fair Labor Standards Act's "suffer or permit" standard to identify employees who are misclassified as independent contractors. The guidance directed WHD staff to consider all six factors to deter-

[59] 29 U.S.C. §201 through §219. *See generally Krause v. Cherry Hill Fire Dist. 13*, 969 F. Supp. 270 (D.N.J. 1997) (providing statutory basis for determining employee status). The FLSA should be read broadly in pursuit of its remedial purpose such that certain volunteer firefighters are employees for FLSA purposes notwithstanding the limited exception contained in 29 U.S.C. §203(e)(4)(A) relating to individuals that receive no compensation. *Id.*

[60] 29 U.S.C. §2601–§2619.

[61] 29 U.S.C. §651–§678. *See Rockwell Int'l Corp.*, 17 BNA OSHC 1801 (1996).

[62] 42 U.S.C. §2000e. *Compare Knight v. United Farm Bureau Mut. Ins. Co.*, 950 F.2d 377 (7th Cir. 1991) (applying economic realities test in determining that insurance agent was independent contractor and not employee), *with Deal v. State Farm County Mut. Ins. Co.*, 5 F.3d 117 (5th Cir. 1993) (using hybrid economic realities/common law right-of-control test in holding that agent was employee and not independent contractor).

[63] 779 F. Supp. 332 (S.D.N.Y. 1991).

[64] *Cf. Wheeler v. Main Hurdman*, 825 F.2d 257 (10th Cir. 1987) (rejecting EEOC argument that economic realities or control test should be applied), cert. denied, 484 U.S. 986 (1987).

[65] 704 F.2d 1465 (9th Cir. 1983). *But cf. Gotay v. Becton Dickinson Caribe, Ltd.*, 257 F. Supp. 2d 498 (D.P.R. 2003), aff'd on other grounds, 375 F.3d 99 (1st Cir. 2004).

[66] *Bonnette*, 704 F.2d at 1470.

[67] 161 F.3d 299 (5th Cir. 1998).

[68] 161 F.3d 299, 303–06.

[69] 137 F.3d 1436 (10th Cir. 1998).

[70] 137 F.3d 1436, 1440.

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mine whether the worker is really in business for him or herself (i.e., an independent contractor) or is economically dependent on the employer (i.e., an employee). Under that guidance, application of the economic realities factors should be guided by the FLSA's statutory directive that the scope of the employment relationship is very broad. No one factor, including control, is determinative of whether a worker is an employee, and the factors should not be applied mechanically. The DOL stated that removal of that guidance does not change the legal responsibilities of employers under the FLSA, as reflected in the regulations and case law.[71] In January 2021, WHD issued a final rule intended to replace the multifactor economic realities test used to assess employment status classifications under the FLSA but withdrew the rule before it took effect.[72] The rule would have provided a 5-factor test that focuses primarily on: the nature and degree of the worker's control over the work; and the worker's opportunity for profit or loss, based on initiative, investment, or both.[73] In January 2024, the DOL rescinded the 2021 rule and replaced it with regulations returning to a totality-of-the-circumstances analysis of the multifactor economic reality test. Under that analysis, those factors do not have a predetermined weight and are considered in view of the economic reality of the whole activity. The final rule provides guidance on how to consider (1) opportunity for profit or loss depending on managerial skill, (2) investments by the worker and the potential employer, (3) the degree of permanence of the work relationship, (4) the nature and degree of control, (5) the extent to which the work performed is an integral part of the potential employer's business, and (6) skill and initiative. Additional factors that are relevant to the overall question of economic dependence may also be considered.[74] However, the DOL indicated its intent to reconsider the 2024 rule, including whether to rescind it, and stopped applying the 2024 rule's analysis when determining employee versus independent contractor status in FLSA investigations. Nonetheless, the DOL indicated that, pending further action, the 2024 rule remains in effect for private litigation.[75]

The economic realities test is, at least in theory, more likely to result in a finding of employee status.[76]

4. Hybrid Test

Other courts have applied a hybrid test that mixes features from both the common law agency test and the economic realities test. The hybrid test looks to both (i) the amount of control vested in the hiring party, and (ii) the worker's level of dependence on the employment relationship. Although not referred to as such, the case that is credited with having established the hybrid test is *Spirides v. Reinhardt*.[77] *Spirides* involved a claim of sex discrimination brought under Title VII of the Civil Rights Act by an individual who was terminated from a civil service job with the U.S. International Communications Agency. The narrow issue before the court was whether the plaintiff was an "employee." The agency urged the D.C. Court of Appeals to apply a limited definition of employee found in the legislation that authorized the Civil Service Commission. The court declined the invitation and instead purported to adopt the economic realities test, saying that: "[The] determination of whether an individual is an employee or an independent contractor for purposes of the [Title VII of the Civil Rights] Act involves, as appellant suggests, analysis of the 'economic realities' of the working relationship."[78] But the court added: "Consideration of all of the circumstances surrounding the work relationship is essential, and no one factor is determinative. Nevertheless, the extent of the employer's right to control the 'means and manner' of the workers' performance is the most important factor to review here, as it is at common law" (citations omitted). What is not clear is whether the hybrid test is fundamentally different from the common law agency test because both tests take into consideration the element of control. One might argue that the economic reality of the employment relationship is simply an additional, non-exclusive factor in the common law agency test.

B. Multi-Factor Test and the Tax Code

Under the Federal Insurance Contributions Act (FICA), employers generally are required to withhold (and remit to the U.S. Treasury) FICA taxes from the pay of their employees, and they also must pay a matching FICA tax equal to the employee portion of the tax.[79] Employers also are obligated under the Federal Unemployment Tax Act (FUTA) to pay a feder-

[71] WHD FLSA Administrator's Interpretation No. 2015-1 (July 15, 2015), withdrawn by DOL News Release No. 17-0807-NAT (June 7, 2017). *See* http://www.dol.gov/whd.

[72] RIN 1235-AA34, 86 Fed. Reg. 1168 (Jan. 7, 2021) (final rule); 86 Fed. Reg. 12,535 (Mar. 4, 2021) (delay of effective date); 86 Fed. Reg. 24,303 (May 6, 2021) (withdrawal of rule).

[73] The withdrawn FLSA rule, which would have applied across all industries, also would have considered to a lesser degree the amount of skill required for the work, the permanence of the working relationship, and whether the work is part of an integrated unit of production. Any additional factors might be relevant only if they in some way indicated whether the individual is in business for himself or herself, as opposed to being economically dependent on the potential employer. 86 Fed. Reg. at 1246–48. The Fifth Circuit vacated a district court decision that the 2021 rule became effective as of March 8, 2021, and remained in effect because the DOL's promulgation of the delay of the effective date of the independent contractor rule and of the subsequent withdrawal of the rule violated the Administrative Procedure Act. *Coal. for Workforce Innovation v. Walsh*, No. 1:21-cv-00130, 2022 BL 128723 (E.D. Tex. Mar. 14, 2022), *vacated and remanded by unpub. order*, No. 22-40316 (5th Cir. Feb. 19, 2024).

[74] 29 C.F.R. §795.100 *et seq.*, added by RIN 1235-AA43, 89 Fed. Reg. 1638 (Jan. 10, 2024), effective March 11, 2024.

[75] *See* DOL WHD FAB 2025-1 (FLSA Independent Contractor Misclassification Enforcement Guidance).

[76] *Compare Hickey v. Arkla Indus., Inc.*, 699 F.2d 748, 751–53 (5th Cir. 1983) (holding that plaintiff was not economically dependent for his livelihood on defendant and rejecting claim that employee status is irrelevant because ADEA covers all individuals having an economic relationship with a business entity), *with* Michael Horne, Thomas Williamson, & Anthony Herman, *Contingent Workforce: Business and Legal Strategies 4–10* (2000) (comparing economic realities test with common law agency test). Horne adds, "Conventional wisdom characterizes the economic realities test as a broader test than the common law agency test. As a result, certain individuals will, presumably, be deemed employees or employers under the economic realities test but not under the common law agency test. Although this observation may be accurate, the two tests still have much in common." *Id. See also Coles v. Harvey*, 471 F. Supp. 2d 46 (D.D.C. 2007); *Mason v. African Dev. Found.*, 355 F. Supp. 2d 85 (D.D.C. 2004).

[77] 613 F.2d 826 (D.C. Cir. 1979).

[78] 613 F.2d at 831.

[79] §3102(a) and §3111. For a discussion of the employment tax rules, see 392 T.M., *Withholding, Social Security, and Unemployment Taxes on Compensation*.

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al unemployment tax on all wages;[80] to withhold income taxes from the wages paid to an employee;[81] to furnish employees with W-2 Forms summarizing their wages;[82] and to submit various reporting forms to the IRS.[83] The employer is liable for both the employee withholding portion and the employer portion of employment taxes. In addition to taxes owed, penalties may also apply for failure to properly collect and pay over required amounts.[84]

In contrast, the obligations to withhold and remit the employee portion of FICA, to pay and remit FUTA and the employer portion of FICA, and to withhold and remit income taxes from employee wages do not apply in the case of independent contractors. Rather, an independent contractor engaged in a trade or business instead is subject to taxation under the Self-Employment Contributions Act of 1954 on net earnings from self-employment.[85] The employer reports the payment of fees to both the IRS and the independent contractor, usually on an IRS Form 1099.[86] Such payments are earned income to the independent contractor. The independent contractor is responsible for paying tax on his or her "net income from self-employment."[87]

If an employer fails to withhold, remit and pay FICA, FUTA or income taxes, the employer remains liable for these taxes and is secondarily liable for the employee's share of the FICA tax. In addition, the employer could be subject to numerous penalties including penalties for failing to file correct information returns with the IRS,[88] for furnishing incorrect information returns to the worker,[89] for failing to file a return,[90] and for failure to pay tax.[91] If the misclassification is intentional, additional penalty provisions apply.

Comment: As a consequence of the added tax costs and reporting burdens, employers have an incentive to misclassify employees as independent contractors. This also has the advantage from the employer's point of view of reducing its fringe benefit costs.

There is no single definition of the term "employee" for federal income tax purposes. The I.R.C. primarily adopts the common law agency test subject to certain exceptions where employment and income tax withholding are concerned. Section 3121(d)(2) defines employee for employment tax purposes as any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of employee. Reg. §31.3401(c)-1(b) adopts this rule for employment tax purposes:

> 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.

Similar rules apply with respect to FUTA and federal income tax withholding under §3306(i) and §3401(c), and Reg. §31.3306(i)-1 and §31.3401(c)-1, respectively.[92]

Any officer of a corporation also is an employee under §3121(d)(1). The Tax Court determined in *Joseph M. Grey Public Accountant, P.C. v. Commissioner*,[93] that an individual who was both the president and the sole shareholder of an S corporation was an employee of the corporation for federal employment tax purposes. Notwithstanding §3121(d)(1), the corporation argued that a corporate officer is not an employee for employment tax purposes unless he is an employee under common law, and that the individual here was not an employee at common law because the corporation never exercised control over him in the performance of his services. Even if the common law control factor was relevant, the court held, the corporation failed to prove that it did not exercise control over the individual in the performance of his services. Furthermore, the court noted, although there was no agreement regarding

[80] §3301. However, §3302 provides for a partial credit against an employer's FUTA obligations for certain state unemployment tax contributions (e.g., payments made to the Massachusetts Department of Employment and Training for the unemployment compensation payroll tax).

[81] §3402. The withholding rules do contain some exceptions that are intended to facilitate the tax collection process. Under §3401(d)(1), the person for whom an individual performs services as an employee is the employer, unless that person lacks control over the payment of the wages, in which case the person in control of paying wages is considered the employer. Under §3401(d)(2), the person paying wages on behalf of a nonresident alien individual, foreign partnership or foreign corporation not engaged in a trade or business in the U.S. is also considered the employer. This is often known as a shadow payroll, as it shadows the employee's actual payroll to facilitate payment of U.S. withholding and employment taxes.

[82] §6051(a).

[83] Reg. §31.6011(a)-1(a), §31.6011(a)-3 and §31.6011-4(a).

[84] §6672. The withheld amounts are treated as trust funds in the employer's hands. The person responsible for withholding, accounting for and paying over the trust fund to the government can be held personally liable for the unpaid amounts. This is so even where the employer is organized as a business corporation.

[85] §1401, as amended by Pub. L. No. 111-148, §9015(b)(1) and §10906(b), and Pub. L. No. 111-152, §1402(b)(1)(B), and §1402, as amended by Pub. L. No. 111-148, §9015(b)(2)(B). One-half of the self-employed individual's employment tax can be deducted from income as a business expense.

[86] §6041.

[87] See §401(c)(1), allowing such an individual to be treated as an employee for purposes of retirement plan contributions.

[88] §6721.

[89] §6722.

[90] §6651(a)(1).

[91] §6651(a)(2).

[92] For a discussion of the FICA, FUTA and income tax withholding rules, see 391 T.M., *Employment Status — Employee v. Independent Contractor*, and 392 T.M., *Withholding, Social Security, and Unemployment Taxes on Compensation.*

[93] 119 T.C. 121 (2002), aff'd, 93 Fed. App'x 473 (3d Cir. 2004). *See Schmidt v. Ottawa Med. Ctr.*, 322 F.3d 461 (7th Cir. 2003) (shareholder-physician was not employee because he shares in control of employer), cert. denied, 540 U.S. 1004 (2003).

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whether the individual performed his services as the corporation's president or in some other capacity, it is fairly inferred that he performed such services as its president because he was president and performed numerous services, and there is no convincing evidence that he performed such services as an independent contractor rather than as president.

1. Revenue Ruling 87-41 — Twenty Factors

Rev. Rul. 87-41 sets out 20 factors to consider in determining whether a worker is an employee for purposes of FICA, FUTA, and income tax withholding. After listing and describing each factor, the ruling then cites to cases or prior rulings that further illustrate its application. The 20 factors are described below:

1. *Instructions.* A worker who is required to comply with another person's instructions about when, where, and how to work ordinarily is an employee. This control factor is present if the person for whom the services are performed has the right to require compliance with instructions. The IRS cited Rev. Rul. 68-598, in which it ruled that driving instructors were employees (rather than independent contractors) of a company that provided automobile driving courses to the public. The company hired and trained the instructors who were required to follow the company's training standards using the company's name and equipment. Also cited was Rev. Rul. 66-381, in which individuals employed by a car rental agency to shuttle cars from one location to another were deemed to be employees, in part, based on the rental car agency's degree of control over the performance of the particulars of their duties. The ruling also noted that the agency maintained the same level of control over the shuttlers as it did over its regular employees.

2. *Training.* Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker or by requiring the worker to attend meetings indicates that the service recipient wants the services performed in a particular manner. Rev. Rul. 70-630 considered the status of sales clerks trained and supervised by a service company that assigned them to retail stores to perform temporary sales services, and whether the service company had the right to direct and control the clerks and supervise the performance of such services. The service company was formed for the purpose of training sales clerks and other temporary personnel and furnishing them to retail establishments. The IRS ruled that the clerks were employees of the service company.

3. *Integration.* Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. The workers who perform certain services necessarily must be subject to a certain amount of control by the owner of the business, the IRS reasoned, "when the success or continuation of a business depends to an appreciable degree upon the performance of certain services." The IRS cited *United States v. Silk*,[94] in which the employer sought to recover employment taxes paid on behalf of two groups of workers. The first group unloaded railway coal cars, and the second group made retail deliveries of coal by truck. The unloaders provided their own tools, worked only when they wanted to work, and were paid an agreed-upon price. But they were supervised by the employer as to the details of their work, and they were an integral part of the employer's business.[95] The truck drivers owned their own trucks, paid the expenses of their operation, employed and paid their own helpers and received compensation on a piecework or percentage basis. The U.S. Supreme Court held that unloaders were employees but that the truck drivers were independent contractors.

4. *Services Rendered Personally.* If services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results. In Rev. Rul. 55-695, a company retained the services of a retired former employee to train a replacement for her job. She worked exclusively for the employer on its premises under the direction of a company manager. She was furnished office space, equipment, and supplies without charge, and she also was reimbursed for expenses incurred on the employer's behalf. The IRS ruled that the individual was an employee.

5. *Hiring, Supervising, and Paying Assistants.* If the person for whom the services are performed hires, supervises, and pays assistants, generally that person has control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, generally the workers are independent contractors. In Rev. Rul. 63-115, individuals were engaged by truck drivers to unload an employer's trucks. Their work was done under the employer's supervision, and they were paid out of the employer's funds. These individuals were considered employees of the employer rather than employees of the truck drivers. In Rev. Rul. 55-593 the IRS reached a different conclusion. Owner-drivers and drivers of rented trucks delivered goods for a company at specified rates pursuant to written agreements. They received payment only for articles delivered, paid all their operating expenses including insurance coverage and were not subject to the direction and control of the company. The IRS ruled that these workers were not employees of the company.

6. *Continuing Relationship.* A continuing relationship between the worker and the service recipient indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring but irregular intervals. The IRS again cited *Silk* in Rev. Rul. 87-41. As described above in item 3 (relating to integration), the defendant sought to recover employment taxes paid on behalf of workers that it treated as independent contractors. In holding that the unloaders

[94] 331 U.S. 704 (1947).

[95] 331 U.S. at 716.

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were employees, the court said the fact that the unloaders did not work regularly was not significant.[96]

7. *Set Hours of Work.* The establishment of set hours of work by the person for whom the services are performed is a factor indicating control. The IRS cited Rev. Rul. 73-591, in which a beautician was deemed to be an employee where she leased a space in the salon, was required to work specific hours, and furnished daily reports to the owner.

8. *Full-Time Required.* If the worker must devote full-time hours to the business of the service recipient, then the service recipient has control over the amount of time the worker spends working and, by implication, restricts the worker from doing other gainful work. An independent contractor, on the other hand, is free to work for others. In Rev. Rul. 56-694, photographers were engaged by an employer to take photographs in the homes of customers who purchased coupons from the employer's canvassers. The photographers were engaged on a full-time basis, required to fulfill all appointments given to them, did not maintain studios of their own, and did not perform photographic services for any other persons. The IRS determined that the photographers were employees.

9. *Doing Work on Employer's Premises.* If the work is performed on the premises of the person for whom the services are performed, especially if the work could be done elsewhere, then that condition suggests control over the worker. Work done off the premises of the person receiving the services, such as at the office of the worker, indicates some freedom from control. But this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Where the service recipient has the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required, then control over the worker is indicated. The IRS cited Rev. Rul. 56-660, in which a writer was engaged on a full-time basis to write a book on the history of an organization. The IRS determined that the failure of the writer to maintain an office was indicia of employee status. The IRS ruled that the writer was an employee of the organization. Also cited was Rev. Rul. 56-694, discussed above at item 8 (relating to the full-time requirement).

10. *Order or Sequence Set.* A worker may be an employee where the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person for whom the services are performed, as indicated where a worker must perform services in the order or sequence set by the service recipient. Often, because of the nature of an occupation, the service recipient does not set the order of the services or sets the order infrequently. It is sufficient to show control, however, if such person retains the right to do so. In Rev. Rul. 56-694, discussed above at item 8 (regarding the full-time requirement), the photographers were required to fulfill all appointments given to them by the employer. Typically, the appointments for taking photographs were specified on each list the employer furnished to the photographers, although this was not always the case.

11. *Oral or Written Reports.* A requirement that the worker submit regular or written reports to the person for whom the services are performed indicates a degree of control. In Rev. Rul. 70-309, a company operated oil wells and engaged oil well pumpers under written contracts. The oil well pumpers monitored the wells, turned on the tanks, gauged the tanks and submitted periodic reports to the company. Even though the oil well pumper contracts stated that the pumpers were independent contractors, the IRS found that they were employees. Similarly, in Rev. Rul. 68-248 individuals who were employed to tune and repair pianos and organs were required to complete service invoice forms that were the equivalent to a report on each job. The IRS determined that the repairmen were employees and not independent contractors.

12. *Payment by Hour, Week, or Month.* Payment by the hour, week, or month generally points to an employer-employee relationship, except where this method of payment is just a convenient way of paying a lump sum as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor. In Rev. Rul. 74-389, commissioned yacht salesmen were determined to be independent contractors because they were free to solicit prospective buyers and listings at their own discretion, were not restricted to a specific territory, were not required to work any regular hours or at any specified time, and were not required to attend scheduled sales meetings.

13. *Payment of Business and/or Traveling Expenses.* If the person for whom the services are performed ordinarily pays the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities. In Rev. Rul. 55-144, the IRS considered the status of an individual hired by a used car dealer to drive cars to an auction company. The dealer instructed the individual with respect to the price at which the cars were to be sold at auction. The driver paid all the expenses of the trip and was reimbursed by the dealer. The IRS ruled that the individual was an employee of the used car dealer.

14. *Furnishing of Tools and Materials.* The fact that the person for whom the services are performed furnishes significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship. Rev. Rul. 71-524 involved a truck driver who performed services for a leasing company. The driver was given daily instructions as to where and when to pick up and deliver merchandise. The leasing company entered into an agreement with the driver in which the gross receipts would be divided on a percentage basis. The leasing company paid for all major repairs, tires, and license plates while the

[96] 331 U.S. 704, at 718.

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driver paid the everyday driving and operational expenses of the vehicle. A key factor in the IRS ruling that the truck driver was an employee of the leasing company was that the leasing company owned the tractor-trailer rig and leased the rig along with the driver.

15. *Significant Investment.* If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, the lack of investment in facilities indicates dependence on the person for whom the services are performed for such facilities and the existence of an employer-employee relationship. Special scrutiny is required with respect to certain types of facilities, such as home offices. The IRS cited again to Rev. Rul. 71-524, which is discussed at item 14 above (relating to furnishing tools and materials).

16. *Realization of Profit or Loss.* A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, the worker generally is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor. In Rev. Rul. 70-309, discussed above at item 11 (relating to oral or written reports), the IRS ruled that the oil well pumpers were not engaged in an independent enterprise because they assumed no business risks.

17. *Working for More than One Firm at a Time.* If a worker performs more than de minimis services for multiple unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each, especially if such persons are part of the same service arrangement. Rev. Rul. 70-572 held that a freelance jockey engaged by a racehorse owner for a single race was an independent contractor because the racehorse owner could not intervene to control the details and means by which the jockey performed his services. Rather, the jockey was bound to obey the rules of the Racing Commission.

18. *Making a Service Available to the General Public.* The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship. The IRS cited again to Rev. Rul. 56-660, discussed above in connection with doing work on an employer's premises. Rev. Rul. 56-660 involved a writer engaged to write a book on the history of an organization. The writer in this instance did not hold himself out to the public as being available to do work of a similar or related nature.

19. *Right to Discharge.* The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is the employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications. In Rev. Rul. 75-41,[97] a physician's professional service corporation provided a variety of services to professionals including secretarial, nursing, dental, and other services of trained professionals. The individuals were recruited, paid, assigned to jobs, provided with employee benefits, and subject to discharge by the physician's professional service corporation (but not the recipient physician). The individuals who provided such services on behalf of the physician's professional service corporation were deemed to be employees.

20. *Right to Terminate.* If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship. In Rev. Rul. 70-309, discussed at item 11 above (relating to oral or written reports), the contracts governing the relationship between the oil well pumpers and the employer were terminable at will. A worker could, therefore, walk away from the job without incurring liability.

Rev. Rul. 87-41 was issued to enable taxpayers to distinguish between an employer-employee relationship and an employer-independent contractor relationship. The individual factors were designed to be accorded different weights depending on the surrounding facts and circumstances. The IRS clarifies the 20-factor test of Rev. Rul. 87-41 in its IRS Worker Classification Training Guidelines: Independent Contractor or Employee (October 1996). While not rejecting the 20-factor test, the IRS was concerned that changing business conditions made some of the factors less useful than they once might have been. The IRS also wanted to ensure that its agents would not be unduly constrained by, but rather would be able where necessary to look beyond, the 20 factors of Rev. Rul. 87-41.

2. IRS Training Guidelines

The IRS Worker Classification Training Guidelines: Independent Contractor or Employee (October 1996), drafted to aid IRS agents in examinations, eschew a rigid listing of factors in favor of a broad-based inquiry that focuses on three considerations: financial control, behavioral control, and the relationship between the parties. The guidelines seek to distill for the IRS field agents the essential features that define the employment relationship in a manner that makes them both accessible and easy to apply in practice. Each category is intended to focus the agent's attention on the sorts of evidence that will support a particular classification. In considering the types of evidence discussed here, the Training Guidelines direct that all relevant information be considered and weighed to determine whether a worker is an independent contractor or an employee. Factors to consider include:

[97] This ruling is discussed at length in IV.A.2.c.

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• *Behavioral Control.* Behavioral control focuses on whether there is a right to direct or control how the work is done. The agent is directed to consider the employer's right to direct or control how the worker performs the specific task for which he or she is engaged. This includes both the extent to which the worker is bound by the employer's specific instructions and the training that the employer furnishes the worker in connection with the performance of his or her duties. The more detailed the instructions are that the worker is required to follow, the more control the business exercises over the worker, and the more likely the business retains the right to control the methods by which the worker performs the work. Conversely, absence of detail in instructions reflects less control. The presence or absence of instructions and training is described as especially relevant. Periodic or ongoing training also is cited as an indicator of behavioral control to the extent that the employer must explain to the worker detailed methods and procedures to be used in performing a task to the employer's specifications. While the Training Guidelines classify this type of training as strong evidence of an employer-employee relationship, they also make clear that not all training rises to this level and that training appropriate to either independent contractors or employees should be disregarded. The Training Guidelines cite orientation or information sessions about the business's policies, a new product line, or applicable statutes or government regulations, as examples of the latter. Lastly, the Training Guidelines make clear that an employment relationship may also exist when the work can be done with a minimal amount of direction and control, such as work done by a stockperson, store clerk, or gas station attendant. The absence of need to control should not be confused with the absence of right to control.[98]

• *Financial Control.* Financial control focuses on whether there is a right to direct or control how the business aspects of the worker's activities are conducted. Financial control focuses on the economic aspects of the relationship, including (i) the significance of any investment made by the worker, (ii) the treatment of unreimbursed expenses, (iii) the services available to the relevant market, (iv) the method of payment, and (v) the opportunity for profit or loss. A significant investment is ordinarily, but not necessarily, evidence of an independent contractor relationship. Some types of work do not require large expenditures, and even if large expenditures (such as costly equipment) are required, an independent contractor may lease rather than purchase the equipment (but it must be at fair market or fair rental value). The extent to which a worker chooses to incur expenses is evidence that the worker has the right to direct and control the financial aspects of the business operations. The Training Guidelines cite potential expenses as such rent and utilities, tools and equipment, training, advertising, payments to business managers and agents, wages or salaries of assistants, licensing/certification/professional dues, insurance, postage and delivery, repairs and maintenance, supplies, travel, leasing of equipment, depreciation, inventory/cost of goods sold, and reimbursed expenses. While employers often pay business or travel expenses for their employees, independent contractors' expenses also may be reimbursed. Therefore, the Training Guidelines focus on unreimbursed expenses, because independent contractors are more likely to have unreimbursed expenses. The method of payment may be helpful in determining whether the worker has the opportunity for profit or loss. A worker who is compensated on an hourly, daily, weekly, or similar basis is guaranteed a return for labor, while the performance of a task for a flat fee generally is evidence of an independent contractor relationship particularly if the worker incurs the expenses of performing the services. Lastly, the Training Guidelines view the ability to realize a profit or incur a loss as perhaps the strongest evidence that a worker controls the business aspects of services rendered.

• *The Relationship of the Parties.* The relationship of the parties focuses on how the parties perceive their relationship. While the parties' written agreement describing a worker as an independent contractor may furnish evidence of the parties' intent, the Training Guidelines emphasize that a contractual designation is not conclusive.[99] It is, rather, the facts and circumstances under which a worker performs services that are determinative of the worker's status.[100] Contractual terms might, however, tip the balance in a close case.[101] Filing a Form W-2 usually indicates the parties' belief that the worker is an employee. But the Training Guidelines cite at least one instance where workers succeeded in obtaining independent contractor status even where Forms W-2 were filed.[102]

3. Exceptions in the I.R.C.

While the common law agency test forms the basis establishing employee status under the I.R.C., the rule is subject to some exceptions and modifications. Self-employed individuals who have earned income from self-employment are allowed to participate in tax-qualified plans.[103] Section 401(c)(1) defines the term "self-employed individual" to mean an individual with earned income, i.e., net earnings from self-employment as defined in §1402(a) but with certain adjustments. Generally these

[98] Worker Classification Training Guidelines, p. 2–14: "The right to control contemplated by Treas. Reg. section 31.3121(d)-1(c)(2) and the common law as an incident of employment requires only such supervision as the nature of the work requires. The key fact to consider is whether the business retains the right to direct and control the worker, regardless of whether the business actually exercises that right."

[99] *Accord Vizcaino v. Microsoft Corp.*, 120 F.3d 1006, 21 EBC 1273 (9th Cir. 1997), modifying 97 F.3d 1187, 20 EBC 1873 (9th Cir. 1996) (designating worker as independent contractor by agreement void by reason of mutual mistake), cert. denied, 522 U.S. 1098 (1998).

[100] *Cf.* Reg. §31.3121(d)-1(a)(3) (classifying as immaterial designation or description of the parties).

[101] *See Illinois Tri-Seal Prods., Inc. v. United States*, 353 F.2d 216, 218 (Ct. Cl. 1965) (rejecting economic realities test and holding that employee status is based on common law rules based on the substance of the arrangement giving weight to all relevant factors).

[102] *Butts v. Commissioner*, T.C. Memo 1993-478, aff'd per curiam, 49 F.3d 713 (11th Cir. 1995).

[103] §401(c) treats a self-employed individual for all purposes of §401 as if the individual were an employee.

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individuals consist of sole proprietors, partners in a partnership, and 2% shareholders of S corporations.

There also are workers who are treated as common law employees solely for employment tax purposes even though they would otherwise be classified as independent contractors under the traditional common law agency test. These statutory employees include: (i) an agent-driver or commission-driver engaged in distributing meat products, vegetable products, fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services; (ii) a full-time life insurance salesman; (iii) a home worker performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by such person which are required to be returned; and (iv) certain full-time traveling or city salesmen.[104] Although statutory employees generally cannot be covered under a qualified plan of the employer, §7701(a)(20) provides for an exception for full-time life insurance salespersons.

Lastly, under §3508, certain individuals who are common law employees are not treated as such for federal income and employment tax purposes. These individuals are referred to as statutory non-employees. They include qualified real estate agents and direct sellers. Qualified real estate agents are licensed real estate agents whose remuneration is based on sales or other output rather than on the number of hours worked. Direct sellers are individuals engaged in the trade or business of selling (or soliciting the sale of) in-home consumer products or newspapers and whose pay is based on sales or other output rather than on the number of hours worked. In each case, there is the further requirement of a written contract specifying that the worker will not be treated as an employee with respect to such services for federal tax purposes.

4. Form SS-8

The IRS has promulgated Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*. Firms and workers can file this form to request a determination of the status of a worker for purposes of federal employment taxes and income tax withholding. The form seeks detailed information that falls into the three basic categories discussed above: (1) Behavioral Control; (2) Financial Control; and (3) Relationship of the Worker and Firm. No one factor stands alone in making this determination.

Comment: While the form is available for a determination as to employment and income tax classification, many employers are reluctant to use it. For example, a response from the IRS that worker is an employee may be difficult to change. For this reason, employers tend to use the form as an assessment tool in determining whether a relationship with a worker may need adjustment. Employees use the form to achieve employee status from an employer. Employers who find themselves subject of a determination that a class of workers treated as independent contractors are employees should consider participation in the IRS Voluntary Reclassification Settlement Program.[105]

C. ERISA

Although ERISA was enacted in part to protect the benefits furnished to employees, the statute's definition of employee is brief, circular, and unhelpful. ERISA §3(6) defines employee to mean any individual employed by an employer. The term employer is defined in ERISA §3(5) to mean any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan. Whether or not intentionally, Congress left it to the courts to flesh out the definition. That opportunity presented itself to the U.S. Supreme Court in *National Mutual Insurance Co. v. Darden*.[106]

From 1962 through 1980, Robert Darden operated an insurance agency under the terms of several contracts he signed with Nationwide Mutual Insurance Company under which he agreed to sell only Nationwide insurance products. In exchange, Nationwide agreed to pay him commissions on all his sales and enroll him in the company retirement plan. The plan provided for certain performance bonuses that were credited to a bookkeeping account. It also provided for an additional termination of retirement payment based on policy renewal fees for the previous 12 months. The contract included a provision under which Darden would forfeit certain retirement accumulations if he competed with Nationwide within 25 miles of his prior business location and within one year following his termination of employment. Nationwide exercised its contractual right to end its relationship with Darden. A month later, Darden became an independent insurance agent, and doing business from his old office, he began selling policies for several of Nationwide's competitors. When Nationwide threatened to cancel Darden's retirement benefits, Darden sued under ERISA §502(a) claiming that his retirement benefits were required to be non-forfeitable under ERISA §203.

ERISA §502(a)(1) furnishes participants in ERISA-covered plans the right to sue to enforce ERISA substantive requirements. ERISA §3(7) defines the term participant to mean any employee or former employee of an employer who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer. Darden had standing to sue in the capacity of a participant, therefore, only if he were an employee. Applying the common law agency test, the District Court held that Darden was an independent contractor and not an employee. It granted summary judgment to Nationwide. In so holding, the court fashioned a three-prong test that would have conferred employee status upon Darden if he could demonstrate that he (i) had a reasonable expectation that he would receive benefits, (ii) relied on that expectation, and (iii) lacked the economic bargaining power to negotiate the plan forfeiture provisions. The Fourth Circuit reversed holding that traditional principles of agency law were inconsistent with the declared policies and purposes of ERISA.

Noting that "we have often been asked to construe the meaning of 'employee' where the statute containing the term does not helpfully define it," the court staked out two possible approaches to the problem: It could infer that, in the absence of any indication to the contrary, Congress intended the term

[104] §3121(d)(3).

[105] *See* IRS Announcement 2011-64, as modified by IRS Announcement 2012-45, and IRS Form 8952 and its instructions.

[106] 503 U.S. 318 (1992).

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to have its common law meaning,[107] or it could look to the purposes of the act to flesh out the intended meaning in the manner suggested by the Fourth Circuit.[108] The court opted for the common law agency test.[109] In so holding, the court rejected the Fourth Circuit's three-prong test and also criticized broadly any attempt to impose an economic realities-type test on ERISA:

> Any such approach would severely compromise the capacity of companies like Nationwide to figure out who their "employees" are and what, by extension, their pension fund obligations will be. To be sure, the traditional agency law criteria offer no paradigm of determinacy. But their application generally turns on factual variables within an employer's knowledge, thus permitting categorical judgments about the "employee" status of claimants with similar job descriptions. Agency law principles comport, moreover, with our recent precedents and with the common understanding, reflected in those precedents, of the difference between an employee and an independent contractor.[110]

In applying the common law agency test, the *Darden* Court took note of both the Restatement (Second) of Agency, §220, which sets out a non-exhaustive list of criteria for identifying the master-servant relationship, as well as Rev. Rul. 87-41, which sets forth the 20-factor test described in II.B.1. But rather than adopt either of these tests wholesale, the court instead announced its own multi-factor test that includes the following items: (1) the hiring party's right to control the manner and means by which the particular result is to be accomplished; (2) the skill required; (3) the source of the instrumentalities and tools; (4) the location of the work; (5) the duration of the relationship between the parties; (6) whether the hiring party has the right to assign additional projects to the hired party; (7) the extent to which the hired party may decide when and how long to work; (8) the method of payment; (9) the role of the hired party in hiring and paying assistants; (10) whether the work is part of the hiring party's regular business; (11) whether the hiring party is in business; (12) the provision of employee benefits; and (13) the tax treatment of the hired party.[111] These factors have come to be known as the *Darden* factors, and they are the standard by which employee status is measured for ERISA purposes.[112]

Following *Darden*, courts have generally refused to recognize a middle ground — e.g., co-employment or other hybrid test (discussed at II.A.4.) — between employees and independent contractors for tax and benefits purposes.[113] This stands in marked contrast to most employment and labor laws that have recognized joint liability. A worker who fails to qualify as an employee under the *Darden* factors is an independent contractor for ERISA purposes.[114]

Comment: The application of the *Darden* factors makes the process of worker classification inherently subjective and risky. No matter how conscientious or careful a plan sponsor might be in applying this test, there is no guarantee that a court or administrative agency will agree with the decision. Any employer that sponsors employee benefit plans and retains the services of contingent workers has some worker reclassification exposure. Without some fundamental changes to the manner in which the contingent workforce is regulated, this exposure will grow in direct proportion to the increase in the use of contingent workers.

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[107] *Comm. for Creative Non-Violence v. Reid*, 490 U.S. 730, 739–740 (1989) (reasoning that Congressional intent should be clear if there is nothing to the contrary). The court added: "Where Congress uses terms that have accumulated settled meaning under … the common law, a court may infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms … . In the past, when Congress has used the term 'employee' without defining it, we have concluded that Congress intended to describe the conventional master-servant relationship as understood by common law."

[108] *Accord Darden v. Nationwide Mut. Ins. Co.*, 796 F.2d 701, 13 EBC 1684 (4th Cir. 1992). "The content of the term 'employee' in the context of a particular federal statute is 'to be construed in light of the mischief to be corrected and the end to be attained.'" (Citations omitted.) 796 F.2d at 706.

[109] While *Darden* did not address the definition of "employee" for I.R.C. purposes, the same common law agency test should apply for I.R.C. purposes. Section 3121 and Reg. §31.3121(d)-1(c)(2) each provide that an employee includes any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

[110] *Darden*, 503 U.S. at 327.

[111] *Darden*, 503 U.S. at 323.

[112] Three of the *Darden* factors are not included in the 20-factor test of Rev. Rul. 87-41. They are: (i) the skill required, (ii) whether the hiring party has the right to assign additional projects to the hired party, and (iii) the tax treatment of the hired party. Other courts have considered additional items. *See, e.g., Rasbury v. Commissioner*, 141 B.R. 752 (N.D. Ala. 1992) (the intent of the parties; the industry practice or custom; the existence of written agreements; and whether the worker is furnished with benefits that are ordinarily provided to employees). *See also Kolling v. Am. Power Conversion Corp.*, 347 F.3d 11, 31 EBC 1513 (1st Cir. 2003) (where plan definition of "employee of the employer" was not well defined, administrator, consistent with prior business practice, was entitled to limit participation only to those employees who received W-2s); *Hensley v. Nw. Permanente P.C. Ret. Plan and Tr.*, 258 F.3d 986, 26 EBC 1769 (9th Cir. 2001) (plan administrator did not act arbitrarily and capriciously when interpreting undefined term "employee" in pension plan by using W-2 definition and not common law definition under *Darden*; nothing in *Darden* requires ERISA plan to cover all common law employees), cert. denied, 122 S. Ct. 815 (2002).

[113] *Cf. Vizcaino v. Microsoft Corp.*, 173 F.3d 713, 755 (9th Cir. 1999) (noting, in dicta, that "even if for some purposes a worker was considered an employee of the agency, that would not preclude his status of common-law employee of Microsoft. The two are not mutually exclusive").

[114] *Landry v. Ga. Gulf Corp.*, 91 Fed. App'x 950 (5th Cir. 2004); *Barnhart v. N.Y. Life Ins. Co.*, 141 F.3d 1310 (9th Cir. 1998).

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III. Coverage of Contingent Workers Under Employee Benefit Plans

While worker misclassification issues affect the maintenance and operation of all types of employee benefit plans, they are of particular concern in the case of tax-qualified pension, profit sharing, and stock bonus plans under §401(a) and certain welfare and fringe benefit plans.[115] With certain exceptions, these plans are for the most part regulated by both the I.R.C. and ERISA. The tax benefits of these arrangements are generally available to employees but not independent contractors, and the penalties for including independent contractors or excluding employees can be significant. The tax-favored status of these plans can be placed at risk in one of two of the following ways, each of which is discussed at greater length below:

- The plan might cover workers who are not employees. This would occur where an employer mistakenly believes that a worker is its common law employee but it later turns out that, based on the applicable tests for employee status, he or she is an independent contractor. Instances of improper inclusion typically occur where the workers, such as insurance agents and other sales professionals, have substantial unreimbursed business expenses and seek to avoid the application of §67, under which deductible unreimbursed business expenses were permitted for taxable years beginning before 2018 as miscellaneous itemized deductions subject to a floor of 2% of adjusted gross income.[116]

- The plan might exclude from participation workers who are employees and otherwise fit within an eligible class of employees. This problem is most commonly encountered when an employer erroneously misclassifies a worker as an independent contractor and the worker is later reclassified, either as a result of an audit or at the direction of a court or administrative agency, as an employee. But the problem can also result when the misclassification results in an eligible employee being erroneously assigned to an ineligible class of employees. A plan that excludes "leased employees" within the meaning of §414(n), for example, might later find that its leased employees do not fit within the statutory definition and, if the workers are common law employees, they may not be excluded from plan participation.

A. Participant Rights Under ERISA vs. Tax Qualification Under the I.R.C.

Title I of ERISA deals with the protection of participant rights under plans, funds, or arrangements that constitute either employee welfare benefit plans[117] or employee pension benefit plans.[118] For this purpose, a pension plan encompasses any arrangement that defers compensation to or beyond termination of periods of covered employment. This term includes all manner of nonqualified deferred compensation arrangements, supplemental executive retirement plans, and tax-qualified pension, profit sharing, and stock bonus plans sanctioned under §401(a).[119] Participants and beneficiaries in ERISA-covered plans derive their legal protections from ERISA Title I. If a plan also is a tax-qualified plan, the tax advantages derive from the I.R.C. and not from Title I of ERISA.[120] The I.R.C. includes several requirements that are not imposed on ERISA-covered pension plans. Failure to satisfy the I.R.C.'s qualification requirements does not make a plan unlawful, but it could result in the forfeiture of significant tax advantages.

Where claims of worker misclassification occur in connection with tax-qualified plans, plan sponsors need to contend with both the substantive rights of plan participants and their beneficiaries under ERISA and the plan qualification requirements. Irrespective of tax-qualification questions, workers who are excluded improperly from plan participation have available to them the following remedies under ERISA:

- ERISA §502(a)(1)(A) authorizes a participant to bring suit to recover the statutory penalty[121] for failing to supply certain requested information. ERISA §3(7) defines a participant as any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan.[122] In *Firestone Tire & Rubber Co. v. Bruch*,[123] the Supreme Court interpreted this definition to mean "either employees in, *or reasonably expected to be in*, currently covered employment … or former employees who have … a reasonable expectation of returning to covered employment or who have a colorable claim to vested benefits."[124] The court stated in *Firestone* that for an individual to establish

[115] Employers that misclassify workers risk violating wages and hour laws, income and employment tax withholding, remittance and reporting requirements, workers compensation rules, collective bargaining agreements and anti-discrimination laws, among others. In addition, employers also risk violating federal laws that require a minimum number of employees in order to apply. These include COBRA and the Age Discrimination in Employment Act (ADEA) (20 employees), the Family and Medical Leave Act (FMLA) (50 employees), the Americans with Disabilities Act (ADA) (15 employees) and certain provisions of the Affordable Care Act (ACA) (50 full time and full-time equivalent employees).

[116] The Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, §11045(a), added §67(g), to prohibit all miscellaneous itemized deductions for taxable years beginning after December 31, 2017, and before January 1, 2026. Section 67(h), as amended and redesignated by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70110(a) and §70110(b)(2), permanently extended the suspension of miscellaneous itemized deductions.

[117] ERISA §3(1).

[118] ERISA §3(2).

[119] ERISA §4(b) specifically excludes from coverage for all purposes under Title I of ERISA: (1) governmental plans; (2) church plans, (unless they elect to be covered); (3) plans maintained solely to comply with workmen's compensation, unemployment compensation, or disability insurance laws; (4) plans maintained outside the U.S. primarily for nonresident aliens; and (5) unfunded excess benefit plans.

[120] The amendments to the I.R.C. enacted by ERISA are originally contained in Title II of ERISA.

[121] Under ERISA §502(c), the penalty is set at $110 per day for violations occurring after July 29, 1997. 29 C.F.R. §2575.502c-3. The prior amount was $100 per day.

[122] *See also* 29 C.F.R. §2510.3-3(d).

[123] 489 U.S. 101, 117–18, 10 EBC 1873 (1989).

[124] (Emphasis added; citations omitted.) *Cf. Shawley v. Bethlehem Steel Corp.*, 989 F.2d 652, 16 EBC 1843 (3d Cir. 1993) (holding group of laid-off workers lacked standing to sue their former employer under ERISA because they were not participants in employer's pension plan based on no reasonable expectation of returning to covered employment).

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that he may be eligible for benefits, and therefore qualify as a participant with standing under ERISA, a claimant must have a colorable claim that (1) he will prevail in a suit for benefits, or that (2) eligibility requirements will be fulfilled in the future. The statutory penalty was imposed in *Abraham v. Exxon*[125] even though the worker was determined to be ineligible to participate in the plan.

• ERISA §502(a)(1)(B) furnishes plan participants the right to bring an action for benefits due, to enforce rights under a plan, or to clarify rights to future benefits. A misclassified worker claiming participant status must demonstrate that he or she is entitled to benefits under the plan's terms. Cases such as *Microsoft* (discussed in III.B.3.) sound a cautionary note here. Had the Microsoft §401(k) plan defined "employee" as "any employee of the employer" with no further elaboration, then the plaintiffs in that case might well have had a claim under ERISA §502(a)(1)(B), among others.

• ERISA §502(a)(3), which authorizes equitable relief, has been read to support a wide range of claims based on breaches of fiduciary duty under ERISA §409 and interference of protected benefits under ERISA §510. The theories on which recovery is based are discussed in VII.A., and VII.B.

• ERISA §510 makes it unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate against a plan participant or beneficiary for exercising any right to which he is entitled under the terms of an employee benefit plan. The protections of ERISA §510 are read broadly to include workers who would have been plan participants but for the unlawful action. (ERISA §510 is discussed at VII.C.) ERISA §511 imposes criminal penalties where the violation is willful.[126]

B. Tax Qualification — Pension, Profit Sharing, and Stock Bonus Plans

The IRS position is that a plan loses its tax-qualified status if it is not operated in accordance with its terms (an operational failure).[127] Plans also can be or become disqualified if the terms of the plan document fail to accurately reflect the changing requirements of law (a plan document failure) or where the plan's coverage does not comport with various coverage and nondiscrimination tests (a demographic failure).[128] When a plan loses its tax-qualified status, there are consequences to the plan sponsor, the plan participants and the trust (or other funding vehicle) that holds plan assets. The plan sponsor loses all or a portion of its deduction for contributions to the plan for the open tax years. In the case of a defined contribution plan with individual accounts, the deduction is disallowed to the extent contributions are not vested. In a defined benefit pension plan, the entire deduction may be disallowed. The plan sponsor also may be liable for the failure to withhold and pay income and employment taxes. Participants generally are taxed on the increases in their vested account balances for the open tax years, but where the violation involves certain nondiscrimination rules, highly compensated employees could find their entire account balances immediately and fully taxable. The trust could lose its tax-exempt status, and trust earnings could become taxable for the open tax years under the rules that apply to complex trusts. Open years are those tax years for which the tax statute of limitations has not yet expired (usually three years; six years in the case of significant under-reporting or fraud).[129]

1. Consequences of Including Independent Contractors

Where an independent contractor is included in a tax-qualified pension, profit sharing, or stock bonus plan, the plan violates the exclusive benefit requirement of §401(a).[130] The result is a qualification failure, i.e., the plan could be disqualified, and corrective measures might be required to reinstate its tax-qualified status. Though not often encountered, the issue has arisen in connection with attempts to manipulate plan coverage and where workers previously treated as employees seek reclassification as independent contractors for other, non-plan-related reasons.

Comment: ERISA §515 provides: "Every employer who is obligated to make contributions to a multi-employer plan under the terms of the plan or under the terms of a collectively bargained agreement shall, *to the extent not inconsistent with law*, make such contributions in accordance with the terms and conditions of such plan or such agreement." (Emphasis added.) But what if a worker who is entitled to receive contributions under the terms of a collective bargaining agreement is not a common law employee? *National Shopmen Pension Fund v. Burtman Iron Works, Inc. and Quality Structures of America, Inc.*[131] raised this question in the context of a claim for delinquent contributions against an employer that was a party to a collective bargaining agreement. The employer employed production and maintenance workers through two temporary employment agencies. It claimed that these workers were not the employer's common law employees based on the *Darden* factors (discussed in II.C.). Therefore, the employer argued, these workers were not entitled to pension contributions. The court disagreed, saying the employer's reliance on *Darden* was "inapposite" because it was ERISA §515 that determined whether these workers were entitled to benefits. If these workers were not common law employees — a question that the court raised but did not

[125] 85 F.3d 1126 (5th Cir. 1996), aff'g 892 F. Supp. 807 (E.D. La. 1995). *See* III.B.5.b.(1).

[126] ERISA §511 provides, in pertinent part, as follows: "It shall be unlawful for any person through the use of fraud, force, violence, or threat of the use of force or violence, to restrain, coerce, intimidate, or attempt to restrain, coerce, or intimidate any participant or beneficiary for the purpose of interfering with or preventing the exercise of any right to which he is or may become entitled" under the plan or Title I of ERISA. ERISA §511 was amended by the Pension Protection Act of 2006, Pub. L. No. 109-280, §623, to increase the fine from $10,000 to $100,000, and the imprisonment time from one year to 10 years, applicable to violations occurring on or after the date of enactment.

[127] *See* Rev. Proc. 2021-30, §5.01(2).

[128] Rev. Proc. 2021-30, §5.01.

[129] For a discussion consequences of plan disqualification and the correction of "qualification failures," see 375 T.M., *EPCRS — Plan Correction and Disqualification.*

[130] Section 401(c) treats a self-employed individual as an employee with respect to a plan that the self-employed individual maintains or that the self-employed person's partnership or S corporation maintains. This provision allows a partner to be included in a plan maintained by the partnership. It does not allow an independent contractor to participate in a plan maintained by a corporation that has retained his or her services.

[131] 148 F. Supp. 2d 60, 26 EBC 2005 (D.D.C. 2001).

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decide — then their participation in the plan would violate the exclusive benefit rule under §401(a) (resulting in plan disqualification) and under ERISA §404 (resulting in a breach of fiduciary duty).

a. Manipulation of Plan Coverage

The problems encountered when non-employees are included in plan coverage are illustrated in *Prof'l & Exec. Leasing, Inc. v. Commissioner*.[132] The petitioner, Professional & Executive Leasing, Inc. (PEL) held itself out as a "management" leasing company. PEL approached owners of small professional practices such as medical doctors, lawyers, dentists and veterinarians, and offered to hire these individuals and immediately lease them back to their professional corporations or businesses, as the case may be. PEL sponsored a series of generous pension and welfare plans. The arrangement resulted in a rich benefit package to the business owner (who was PEL's employee and was covered under PEL's benefits plans) from which the business owner's employees (who were not PEL employees) were entirely excluded. PEL did conduct a pre-employment investigation to determine that the worker was duly licensed, and it nominally retained the right to fire the worker, but the companies to which the workers were leased provided the tools, equipment, and office space. The worker had no right to bind PEL contractually, and PEL had no right to interfere with the worker's exercise of his or her professional judgment. The case came to the courts following the IRS's denial to issue a favorable determination letter with respect to PEL's money purchase pension plan based on its failure to satisfy the minimum coverage rules of §410(b).

The court first looked to §220 of the Restatement (Second) of Agency for guidance in determining whether the workers were employees. It then adopted a multi-factor test that included the following seven criteria: (1) the degree of control exercised over the details of the work, (2) investment in the work facilities, (3) opportunity for profit or loss, (4) whether the type of work is a part of the principal's regular business, (5) right to discharge, (6) permanency of the relationship, and (7) the relationship the parties think they are creating. Noting that the terms of a contract claiming independent contractor status cannot override the application of the common law factors, the court concluded, based on a lengthy discussion of each factor, that the workers were not common law employees of PEL.

Jacobs v. Commissioner[133] illustrates the reverse of the problem encountered in *PEL*. In *Jacobs*, the petitioner, who was the CEO, sole director and sole shareholder of two corporations for which he performed substantial services, reported $25,000 in 1985 and $50,000 in 1986 on Schedule C as income from "consulting services." The corporations each operated a gas station. Petitioner also worked for another corporation, a gasoline distributor, which he owned in equal shares with his parents. He received a salary from the distributorship that he reported as wages subject to FICA. The petitioner took deductions from his Schedule C income for Keogh contributions in the amount of $3,000 in 1985 and $10,000 in 1986. The IRS disallowed the deductions, asserting that petitioner was not a self-employed "consultant" entitled to make Keogh contributions, but rather an employee of the corporations. At issue was whether the corporations paid the petitioner as an employee or as an independent contractor. If the petitioner was an employee of the corporations, he was not eligible to make deductible Keogh contributions. The court looked to §3121(d) and Reg. §31.3121(d)-1(b) (defining the term "employee" to include "any officer of a corporation" except an officer who, as such, performs only minor services for the corporation and neither receives nor is entitled to receive any remuneration). Applying the 20-factor test set out in Rev. Rul. 87-41, the court held that the petitioner was the common law employee of the corporations for which he performed services and of which he was an officer.

b. The "Insurance Agent" Cases

Another instance in which the coverage of independent contractors has arisen with some frequency is the situation in which a worker who is covered under the plan of an employer as a common law employee seeks reclassification as an independent contractor. In a series of income tax cases, insurance agents have successfully argued that they are independent contractors and not common law employees. The motivation stems from the treatment of unreimbursed business expenses. Unreimbursed employee business expenses only could be deducted from adjusted gross income under §67 as "below-the-line" miscellaneous itemized deductions for taxable years beginning before 2018. Such deductions, sometimes classified as "second-tier," were deductible only to the extent their aggregate amount exceeded 2% of the taxpayer's adjusted gross income.[134] They also were subject to the alternative minimum tax (AMT). In contrast, business expenses of self-employed individuals are deductible in full to the extent that they qualify as reasonable and necessary business expenses under §162, and they are not subject to the AMT.

The issue was dissected at length in a series of cases described below involving agents of Allstate Insurance Company that participated in its "Neighborhood Office Agents" (or "NOA") program. The NOA program gave the Allstate agents a great deal of autonomy. The agents arranged for office space, hired, fired, and paid their employees, and fixed the terms and conditions of their employment. Except for an office expense allowance that was tied to gross production, the agent was responsible for all of his or her own expenses. Allstate provided certain retirement and fringe benefits to the agents and their employees. The agents agreed as a part of the NOA arrangement to devote their entire time and attention to the business of selling Allstate insurance, and they were contractually bound not to represent or solicit insurance for any other company without Allstate's consent.

Comment: An unusual feature of these cases, and the item that perhaps caught the attention of the IRS, is that the agents routinely deducted their business expenses on Schedule C (as

[132] 89 T.C. 225, 8 EBC 2153 (1987), aff'd, 862 F.2d 751, 10 EBC 1627 (9th Cir. 1988).

[133] T.C. Memo 1993-570, 17 EBC 2225 (1993).

[134] The Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, §11045(a), added §67(g) to prohibit all miscellaneous itemized deductions for taxable years beginning after December 31, 2017, and before January 1, 2026. Section 67(h), as amended and redesignated by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70111(a) and §70110(b)(2), permanently extended the suspension of miscellaneous itemized deductions.

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though they were self-employed) rather than on Schedule A (which is proper if they are employees). Allstate at all times treated the agents as employees, however. It paid employment taxes on their behalf and withheld and remitted income taxes as required by law. There was, as a consequence, a mismatch between the tax treatment claimed by Allstate and that claimed by the agents.

Relevant cases include:

(i) *Butts v. Commissioner*.[135] This was the first case to consider the issue of worker status under the NOA. The court applied a multi-factor test and determined that the agent was an independent contractor notwithstanding his treatment as an employee by Allstate. As a result, he could deduct office expenses as Schedule C business expenses.

(ii) *Smithwick v. Commissioner*.[136] The IRS determined a deficiency in the petitioner's 1988 federal income tax claiming that the petitioners were employees rather than independent contractors. Relying on its earlier decision in *Butts*, the court held for the agents.

(iii) *Mosteirin v. Commissioner*.[137] The facts in this case varied slightly from *Butts* and *Smithwick* in that the agent was terminated from the NOA program for failing to perform according to standards established by Allstate and for certain other underwriting irregularities. The IRS argued unsuccessfully that Allstate's disciplinary actions in the matter evidenced a level of control that was absent in the earlier cases.

(iv) *Lozon v. Commissioner*.[138] This case reached the same result as the prior three cases, but it is notable for its extended discussion of the issues relating to the tax-qualified profit sharing and pension plans maintained by Allstate under which the petitioners were covered. The IRS argued that plan contributions should be currently included in income under the rules of I.R.C. §402(a) and §83(a) to the extent vested. The petitioners responded that (i) they should be deemed to be employees for plan purposes even though they were independent contractors for all other purposes, (ii) §401(c) specifically allows plans to cover independent contractors, and (iii) §83(e) specifically exempts a participant in a tax-qualified plan from the application of §83(a). The court did not find it necessary to address the first two arguments, which were probably specious in any case.[139] The court did, however, accept the petitioner's third argument, namely, that the exception set out in §83(e) applied.[140] It appears that the IRS never questioned the tax-qualified status of the Allstate plans. Rather, it attempted to selectively tax participants who violate the exclusive benefit rule without affecting the balance of the plan. The court rejected this approach reasoning that the IRS wanted to "remove the 'bad apples' from the Allstate pension 'barrel' without advocating that the plans themselves be disqualified" — a proposition for which the court was unable to find a statutory framework.

Comment: By including independent contractors, even if inadvertently, the Allstate plan should have been disqualified, and the exception furnished by §83(e) should not have applied. It appears that the IRS was reluctant to take what was perhaps then a radical step by insisting on total disqualification of the Allstate plans. Significantly, this case arose prior to the issuance of Rev. Proc. 98-22,[141] in which the IRS consolidated its various voluntary correction programs and expanded Walk-in Closing Agreement Program to allow for the correction of certain exclusive benefit violations. Prior to that time, the availability of a correction was uncertain.[142] The matter is now governed by the EPCRS, under which the sanction urged by the IRS and rejected by the court might well work. In retrospect, this case must be particularly galling for the IRS because Lozon was subsequently able to convince the Tax Court to award him attorneys' fees.[143]

The cases relating to the employment status of insurance agents are not confined to the Allstate NOA program. *Feivor v. Commissioner*[144] involved an American Family Insurance Company agent who claimed independent contractor status and paid taxes as such. The IRS asserted deficiencies in Feivor's 1987 and 1988 income tax returns claiming that he was an employee. Feivor was nominally a "district manager" for American Family. While he was subject to some limits on the types of insurance products that he sold, his success was measured on results rather than the manner and means of their achievement. He also had a great deal of latitude in hiring and firing employees. After an exhaustive analysis of the *Darden* factors, the court sided with Feivor and determined that he was an independent contractor and not an employee as was urged by the IRS. *Simpson v. Commissioner*[145] reached a similar result. Simpson was an agent for State Farm Mutual Life Insurance Group ("Farmers") from 1958 through 1974. The agreements with Farmers characterized Simpson as an independent contractor for all purposes. Simpson failed to file any self-employment tax returns or pay any self-employment taxes, claiming instead that he was a Farmers' employee. Applying the seven-factor test adopted

[135] T.C. Memo 1993-478, aff'd per curiam, 49 F.3d 713 (11th Cir. 1995).

[136] T.C. Memo 1993-582, aff'd sub nom. *Butts. v. Commissioner*, 49 F.3d 713 (11th Cir. 1995).

[137] T.C. Memo 1995-367.

[138] T.C. Memo 1997-250.

[139] There is no authority anywhere in the context of the rules that govern tax-qualified pension, profit-sharing and stock bonus plans for the "dual status" urged by the petitioners, and §401(c) is not nearly so broad as to sanction the participation of independent contractors in the plan of a corporate employer for which the contractor performs services. To read §401(c) in this manner would make a mockery of the exclusive benefit rule.

[140] *But see Wickum v. Commissioner*, T.C. Memo 1998-270 (taxpayer concedes that reclassifying taxpayer from employee to independent contractor requires that qualified plan contributions be taken into income currently to the extent vested; court does not address the question).

[141] Rev. Proc. 98-22 has since been superseded. The IRS's Employee Plans Compliance Resolution System (EPCRS) describes the voluntary correction program and is discussed in 375 T.M., *EPCRS — Plan Correction and Disqualification*.

[142] In Rev. Proc. 92-89, the IRS established on a temporary basis the Voluntary Compliance Resolution (VCR) Program that generally allowed plan sponsors to voluntarily correct operational failures in their plans. The VCR Program was extended by Rev. Proc. 93-36 and made permanent in Rev. Proc. 94-62. Further changes to VCR were made in Rev. Proc. 96-29 relating to eligibility standards and the circumstances under which a plan is determined to be under examination. It was not until Rev. Proc. 98-22, however, that exclusive benefit violations could be corrected under VCR.

[143] T.C. Memo 1997-537.

[144] T.C. Memo 1995-107.

[145] 64 T.C. 974 (1975).

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in *PEL*, the court concluded that Simpson was an independent contractor. The outcome of both these cases depended on a straightforward analysis of the *Darden* factors. The cases aptly demonstrate the intensely factual nature of the *Darden*-style inquiry.

Post-*Darden*, the Sixth Circuit's holdings have suggested that the test for employee status where benefit plans are concerned might not differ from the common law agency test. In *Ware v. United States*[146] the Sixth Circuit held that a general insurance agent was an independent contractor and, as such, could deduct his unreimbursed business expenses free of the 2% of AGI limit. In *dicta*, the court stated that control and supervision might be less important in analyzing the classification of a worker for employee benefit purposes. This approach is difficult to square with *Darden* and applicable Treasury regulations.

c. The Allstate NOA Settlement

The success enjoyed by the Allstate agents against the IRS created a significant problem for Allstate: *Lozon* notwithstanding, its tax-qualified plans covering its agents likely violated the qualification requirements. In September 1998, Allstate entered into an agreement with the IRS with respect to the treatment of the pension and profit sharing benefits of the agents.[147] Although that agreement was not made public, the IRS has — at least in their informal remarks — endorsed the approach taken in PLR 9546018, discussed below.

d. Private Letter Ruling 9546018 — Reclassified Workers

The reclassification of insurance agents as independent contractors poses at least two problems where tax-qualified plans are concerned: first, will the plan be treated as violating the exclusive benefit rule by reason of covering a worker that is retroactively determined to be an independent contractor, and second, what does the plan sponsor do with the accruals under the plan for the reclassified worker?

In PLR 9546018, an employee, X, took the position on his federal income tax returns that he was an independent contractor for purposes of deducting his unreimbursed business expenses. X included the amount reported by the company for which he performed services (C) as wages in income, but he claimed his business deductions relating to his performance of services on Schedule C rather than Schedule A. X did not pay any self-employment tax. The IRS issued a statutory notice of deficiency, arguing that X was an employee and that his business expenses were allowable only on Schedule A (as unreimbursed employee business expenses), deductible only to the extent that they exceeded 2% of X's adjusted gross income. The Tax Court held that X was performing services for C as an independent contractor during the years in question.

X participated in C's §401(k) plan and defined benefit plan. C's §401(k) plan incorporates the exclusive benefit rule. The §401(k) plan defines "participant" as any present or former employee who has completed certain requirements. C's defined benefit plan contains similar restrictions. C made contributions on X's behalf to the plans, and X made elective contributions to the §401(k) plan. X also participated in a company-sponsored medical plan, group-term life insurance arrangement and cafeteria plan.

In response to C's requests for rulings on employment and income withholding tax issues and operating the tax-qualified plans, the IRS issued the following rulings:

(i) *Ruling 1.* With respect to the employment and withholding tax, the IRS required C to issue corrected W-2 Forms and 1099s for all prior years beginning with the first year in issue in the Tax Court proceedings. The corrected W-2 Forms were to show $0 in compensation and the 1099s were required to show all compensation plus the value of those fringe benefits that are not available to independent contractors, including cafeteria plan deferrals, group health insurance, group term life insurance.

(ii) *Ruling 2.* Citing the exclusive benefit rule, the IRS next determined that X's continued participation in the C's tax-qualified retirement plans was inconsistent with the Tax Court's determination that X was an independent contractor.

(iii) *Ruling 3.* The IRS next determined that C's tax-qualified plans would not be disqualified provided corrective actions were undertaken. Specifically, C was required to refund to X his §401(k) elective deferrals with earnings. These amounts were taxed to X under §83 and included on a Form 1099 for the year in which they were distributed. C also was required to cancel X's accruals under the defined benefit pension plan (but no amounts in the trust fund would be returned to C).

Comment: Immediately following the issuance of PLR 9546018, and for some time thereafter, it was expected that the IRS might reconsider Rulings 2 and 3 as a part of a larger effort to provide comprehensive guidance on the plan-related aspects of worker misclassification and re-classification. For now at least, the IRS appears to have abandoned that effort.

In describing the tax treatment of the §401(k) elective deferrals, the IRS also determined that the portion of the distribution attributable to otherwise closed tax years are nonetheless taxable under the "duty of consistency doctrine." Under that doctrine, a taxpayer is barred from claiming the benefit of the statute of limitations where "(1) the taxpayer has made a representation or reported an item of income for tax purposes in one year, (2) the IRS has acquiesced in or relied on that fact for that year, and (3) the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessment bars adjustment for the initial year."[148]

[146] 67 F.3d 574 (6th Cir. 1995). *See also Jammal v. Am. Family Ins. Co.*, 914 F.3d 449 (6th Cir. 2019) (a group of insurance agents that had signed agent agreements as "independent contractor[s] for all purposes" were, in fact, independent contractors; in the ERISA context, the inquiry is guided by the financial structure of the company-agent relationship).

[147] *See* 98 Tax Notes Today 178-23.

[148] *Beltzer v. United States*, 495 F.2d 211, 212 (8th Cir. 1974). *See also Stearns v. United States*, 291 U.S. 54 (1934) (duty of consistency holds taxpayer to representations made for tax purposes if IRS acquiesced in or relied on it and statute of limitations bars adjustment for the earlier year); *Estate of Ashman v. Commissioner*, 231 F.3d 541, 25 EBC 1586 (9th Cir. 2000) (finding personal representative of decedent who underreported qualified plan distribution is estopped from claiming any adjustments are time barred).

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Prior to development of the Employee Plans Compliance Resolution System (EPCRS),[149] neither the voluntary correction programs nor Audit CAP were available to correct violations of the exclusive benefit rule resulting in the diversion of plan assets. Although EPCRS speaks in terms of "egregious" violations and is also unavailable for qualification failures relating to the diversion or misuse of plan assets, the phrase "exclusive benefit" is conspicuously absent. This change is particularly significant in the context of worker misclassification where a plan mistakenly or inadvertently covers independent contractors. While the coverage of non-employees is clearly an exclusive benefit violation, it is not necessarily egregious, and while the violation may on its face appear to involve the diversion or misuse of plan assets, the IRS has informally at least indicated its willingness to entertain correction of qualification failures in worker misclassification cases under EPCRS.

2. Consequences of Excluding a Covered Employee

If an employer excludes a common law employee from plan participation erroneously (or intentionally) believing the employee to be an independent contractor, and if the excluded employee is within a class of employees otherwise eligible to participate in the plan, then the plan will experience an "operational failure"[150] resulting in possible plan disqualification. A plan may, for example, define the class of eligible employees as "any employee of the plan sponsor," and then simply be mistaken in its belief that a particular worker is not an employee. Once the employee satisfies the plan's eligibility waiting period, if any, he or she should be admitted to participation. If the misclassified employee is in an excluded class of employees, then the plan's nondiscrimination testing will be affected. Either way, the tax consequences are potentially serious. They include the following possible violations:

(a) Both the safe harbor and general nondiscrimination tests of Reg. §1.401(a)(4)-2(b) and §1.401(a)(4)-2(c) (with respect to defined contribution plans) and Reg. §1.401(a)(4)-3(b) and §1.401(a)(4)-3(c) (with respect to defined benefit plans) are performed taking into account the employees of the plan sponsor and the employers in the controlled group or under common ownership. Excluding employees from the count invariably will affect the outcome, and if sufficient numbers of non-highly compensated employees are excluded, then the tests will not be satisfied. This problem is particularly acute in small, cross-tested plans where minor changes in demographics have the capacity to dramatically affect the coverage of each "rate group" being tested. Similarly, both the testing of (i) benefits, rights and features under Reg. §1.401(a)(4)-4, and (ii) plan amendments under Reg. §1.401(a)(4)-5 depend on the proper identification of employees.

(b) The actual deferral percentage (ADP) test of §401(k)(3)(A) requires the calculation of actual deferral ratios for the highly compensated employees and non-highly compensated employees in the manner prescribed by §401(k)(3)(B). When an eligible employee makes no deferral, Reg. §1.401(k)-2(a)(3)(i) assigns the value of zero to his or her deferral ratio. An eligible employee that is erroneously or improperly excluded from plan participation is nonetheless required to be included in the calculation of the ADP test. The same reasoning holds true for the actual contribution percentage (ACP) test of §401(m)(3). In such case, improperly excluded employees must be included in the count if they would otherwise be eligible employees under the terms of the plan.

(c) Section 401(a)(26) generally requires that tax-qualified defined benefit plans cover the lesser of 50 employees or 40% of all "employees" determined on a control group basis. For this purpose, employees excludible under §410(b)(3) (relating to employees covered under certain collective bargaining agreements) and §410(b)(4)(A) (relating to minimum age and service requirements) also are excluded for purposes of this calculation. The improper exclusion of employees will affect the result of this test.

(d) Both the ratio percentage test of §410(b)(1) and the average benefits test of §410(b)(2) require the coverage of certain specified levels of employees. Of particular significance in this regard is the application of the numerical "nondiscriminatory classification" prong of the average benefits test in Reg. §1.410(b)-4(c). That provision is important not only for the application of the coverage tests under §410(b) but also with respect to the testing of rate groups under Reg. §1.401(a)(4)-2(c)(3) and §1.401(a)(4)-3(c)(2). Plan sponsors encounter another, very practical problem where employees are excluded in error. The coverage rules generally require the plan sponsor to track an employee's service in order to determine when the employee must commence plan participation. Section 410(a)(1)(A) generally requires that an eligible employee enter a plan not later than the date on which he or she attains age 21 and completes one year of service.[151] Under §410(a)(3)(A), the term "year of service" is defined as 1,000 hours of service within a specified measuring period, and §410(a)(3)(C) defines "hour of service" with reference to regulations prescribed by the Secretary of Labor.[152] Unless the plan sponsor has kept an accurate record of hours worked, it will be unable to determine the amount of service to which a reclassified employee might be entitled. Moreover, for purposes of the service crediting rules, the term "employee" also includes leased employees within the meaning of §414(n).[153] Service as a §414(n) leased employee therefore counts for plan participation and vesting purposes even if leased employees are excluded from plan participation. This will become important if the leased employee thereafter transfers to the employer's regular payroll without incurring a break in service.

[149] Discussed in 375 T.M., *EPCRS — Plan Correction and Disqualification.*

[150] *See* Rev. Proc. 2021-30, §5.01(2)(b).

[151] *See* §410(a)(4) (providing that actual participation must commence no later than the first day of the plan year following the date on which the employee first satisfies the plan's age and service conditions or six months after such date, if earlier).

[152] 29 C.F.R. §2530.200b-2(a). The term "hour of service" means generally any hour for which the employee is, directly or indirectly, entitled to compensation either by reason of the performance of duties or for certain reasons unrelated to the performance of duties, such as vacation or sick leave. 29 C.F.R. §2530.200b-2(a).

[153] §414(n)(3)(B).

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(e) Where the requirements of §410(b)(5) and Reg. §1.414(r)-1 are satisfied, employers in the same controlled group of employers are permitted to separately test plans maintained by a qualified separate line of business (QSLOB). But as is the case with the basic §410(b) coverage tests, many of the underlying QSLOB requirements require the tracking of employee data. In particular, passing administrative scrutiny requires that an employer track the employees of each QSLOB.[154]

(f) The service crediting issues described above in connection with the coverage provisions of §410(b) apply as well in the case of vesting under §411.

(g) Section 414(q) defines the term "highly compensated employee" to mean any employee who: (i) was a 5% owner at any time during the year or the preceding year; or (ii) for the preceding year had compensation from the employer in excess of $80,000 (as indexed for inflation).[155] There also is an elective provision under which the class of highly compensated employees can be limited to employees who are in the top-paid group of employees (i.e., the group consisting of the top 20% of employees when ranked on the basis of compensation paid). Where an employee is improperly excluded, the determination of who is or is not a highly compensated employee may be affected.

(h) Where the benefits under a qualified retirement plan accrue primarily for the benefit of key employees, the plan may become top-heavy, in which case the I.R.C. imposes certain additional requirements. They include the need for additional contributions to, and accelerated vesting of, the account of non-key employees. The term "key employee" is defined to mean: (i) an officer with compensation in excess of $130,000 (adjusted for inflation in $5,000 increments); (ii) a 5% owner; or (iii) a 1% owner with compensation in excess of $150,000.[156] The term "employee" includes §414(n) leased employees.[157] Because the determination of top-heavy status is made with reference to employees, the exclusion of an employee from the calculation as a consequence of misclassification might affect the composition of the top-heavy group.

Kenney v. Commissioner[158] describes a particularly egregious example of improper exclusion of employees leading to plan disqualification. Kenney's problems appear to have come to the attention of the IRS as a result of his arrest on charges of taking bribes and money laundering while an Arizona state representative. Prior to his arrest, he worked as an attorney in the audit and tax divisions of two major accounting firms, an attorney for the IRS, and in his own private law firm. He also owned a real estate development firm that sponsored a profit sharing plan and a money purchase pension plan. Under each plan, employees became participants after attaining age 21 and accruing a year of service. Kenney was a highly compensated employee within the meaning of §414(q), and he was also the only participant in either plan. Kenney had two workers, Kevin Peterson, who was described by the court as an "essential part of the business," and Delia McDonald, the "general office secretary" and full-time employee. Kenney treated both Peterson and McDonald as independent contractors, but neither of these individuals claimed any Schedule C income. The Tax Court, applying a multi-factor test, held that Peterson and McDonald were employees and that the plan failed to meet the minimum coverage requirements of §410(b) as a result.[159]

Jim's Window Service, Inc. v. Commissioner[160] reached a contrary result. During 1968, the petitioner, who was engaged in the window washing business, retained eight individuals to perform window washing services. These individuals executed identical contracts. Each contract provided that the petitioner would obtain window washing contracts and subcontract them to these individuals as independent contractors. The subcontractors were required to provide their own labor, materials, tools, equipment and transportation necessary and incidental to performing the window washing services. The subcontractor could hire additional employees, and he was responsible for all injuries and damages. The petitioner was responsible for billing the customer. He remitted 70% of the proceeds to the subcontractor upon completion of the job to the petitioner's satisfaction. Petitioner maintained a pension plan that did not cover the subcontractors. On its 1968 return, the petitioner claimed an $860.08 deduction for contributions to the plan. The IRS disallowed the deduction on the grounds that the subcontractors were employees of the petitioner, and therefore the plan was not tax-qualified. Applying a common law standard, the court sided with the petitioner.[161]

Qualification failures resulting from the improper exclusion of workers from plan participation can usually be corrected under the EPCRS. Correction, however, can be costly. The EPCRS sets out model correction procedures that generally require the plan sponsor to make up for contributions that would have been made to the account of improperly excluded employees together with earnings.[162] There is no model correction where an independent contractor is improperly covered.

[154] Reg. §1.414(r)-1(b)(2)(iv)(D).

[155] For current and prior amounts, see the Worksheets of 371 T.M., *Employee Plans — Deductions, Contributions, and Funding.*

[156] §416(i)(1)(A).

[157] §414(n)(3)(b).

[158] T.C. Memo 1995-431.

[159] Reg. §1.410(b)-2(b)(2) and §1.410(b)-2(b)(3). To satisfy the minimum coverage requirements for a plan year, a plan must pass at least one of two tests. Under the "ratio percentage" test, the percentage of all of an employer's non-highly compensated employees who benefit under the plan for the plan year must be at least 70% of the percentage of the employer's highly compensated employees who benefit under the plan for that plan year. Under the "average benefits test" a plan must benefit a classification of employees each plan year that does not discriminate in favor of highly compensated employees (the "nondiscriminatory classification test"), and the "average benefit percentage" of the plan's non-highly compensated employees must be at least 70% of the average benefit percentage of its highly compensated employees, expressed as a percentage of compensation (the "average benefit percentage test"). Assuming that Peterson and McDonald are both non-highly compensated employees, the plan's ratio percentage is 0%. The plan will fail if either one is highly compensated because, even though 50% of the company's highly compensated employees are covered, the percentage of non-highly compensated employees is zero.

[160] T.C. Memo 1974-115.

[161] *Cf. Dooley v. United States*, 75-2 USTC ¶13,085 (E.D. Tenn. 1975) (distributions from a plan that covered only county officials but not other employees were not entitled to exclusion from the federal estate under former §2039(c)(1)).

[162] *See* Rev. Proc. 2021-30, Appendix B.

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3. The Microsoft Case

The case that came to be styled *Vizcaino v. Microsoft* is technically nothing more than another improper exclusion case that ordinarily would not merit any extended discussion. But to view the case in this manner is to miss its true significance. The case, which has come to be known in benefits circles as "the *Microsoft* case" or simply "*Microsoft*," is perhaps the seminal case on the subject of worker classification and employee benefits issues. This case has been credited with almost single-handedly focusing the attention of workers, employers, employee benefits practitioners, the plaintiff's bar, the regulators, academics, and others to worker classification issues, and it has been the subject of academic commentary.[163]

a. Facts

Microsoft Corporation had a core staff of permanent employees, some full-time and others part-time, that together constituted its "regular employees." Regular employees filled approved, budgeted positions. These employees were provided with a full panoply of benefits that included vacation, sick leave, paid holidays, short-term disability, a §401(k) plan and an employee stock purchase plan.

Sometime prior to 1987, Microsoft began to supplement its regular work with the services of individuals who were variously referred to as "independent contractors" or "freelancers." Freelancers often worked side-by-side with regular employees. They were assigned jobs such as "production editors," "proofreaders," "formatters," "indexers," and "testers." They were hired on a temporary basis, and they were terminated at the conclusion of the particular project or task for which they were hired. As such, they satisfied a production need by giving Microsoft access to a workforce that was capable of quick expansion or contraction. Microsoft eventually developed a pool of freelancers, and, as a result of the expanding volume of work, was able to engage some freelancers for successive projects with no breaks in work.

Freelancers generally received higher base compensation than regular employees, but they were excluded from participation in all of the company's employee benefit plans, including the §401(k) plan and its employee stock purchase plan. These workers were further required to sign an agreement acknowledging that (i) they were independent contractors, not Microsoft employees, (ii) they were ineligible to participate in any of the company's employee and fringe benefit plans, and (iii) they, and not Microsoft, were responsible for their federal and state taxes, withholding, Social Security, insurance, and other benefits. Microsoft did not withhold or remit employment or income taxes.

Freelancers were not paid out of Microsoft's payroll accounts; rather, they were paid from, and required to submit invoices to, the company's accounts payable department. In addition to the manner of payment, Microsoft treated its freelancers differently in other respects. Their orientation was less formal than that given to regular employees; they were given different color I.D. badges; unlike regular employees, they rarely had private offices or cubicles, and they were excluded from playing on the company softball teams and attending company picnics.

In the fall of 1989, the IRS conducted an employment tax audit of Microsoft and determined that, based on common law concepts, the freelancers were not independent contractors but were employees for federal tax purposes. In response, Microsoft made offers of employment to some of the freelancers and gave the remaining freelancers the option of terminating their contracts and employing them through one of several staffing firms. The temporary agencies provided payroll services for the converted freelancers. While most of the freelancers ultimately accepted employment with the temporary agencies, they noticed little if any change in their working conditions.

b. The District Court

Donna Vizcaino was one of a handful of Microsoft freelancers who refused to convert to a temporary agency. She and eight other similarly situated freelancers filed suit as a proposed class action against Microsoft claiming that, as employees, they were entitled to coverage under Microsoft's employee benefit plans. Their initial prayer for relief included claims for certain welfare benefits (including group life insurance benefits and long-term disability insurance), §401(k) plan benefits and participation in the company's employee stock purchase plan.[164] The district court granted summary judgment in Microsoft's favor.[165] The court also certified as the plaintiff class, "all persons employed by the Microsoft Corporation in the United States who are denied employee benefits because they are considered independent contractors *or employees of third-party employment agencies*, but who meet the definition of employees of Microsoft Corporation under the common law."[166] (Emphasis added.)

Comment: The definition of the plaintiff class was important. Microsoft wanted the class to be limited to those freelancers affected by its settlement with the IRS. By including "employees of third-party employment agencies" the class of plaintiffs extended well beyond the workers reclassified as a result of the IRS audit to include employees hired through temporary staffing agencies either before or after Microsoft's settlement with the IRS.

The plaintiffs appealed the decision with respect to two plans, the Savings Plus Plan (SPP) and the Employee Stock Purchase Plan (ESPP). The SPP was a §401(k) plan that allowed for pre-tax employee salary deferrals and an employer matching contribution; ESPP was a broad-based stock purchase plan sanctioned by §423 that allowed employees to purchase Microsoft stock at a 15% discount.

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[163] *See, e.g.*, Mary Clare Gartland, *Independent Contractors and Qualifying Corporate Pension Plans Under the Employee Retirement Income Security Act After Vizcaino v. Microsoft Corp.*, 49 Cath. U. L. Rev. 505 (2000); Paul Kellogg, *Independent Contractor or Employee: Vizcaino v. Microsoft Corp.*, 35 Hous. L. Rev. 1775 (1999); Case Comments, *Ninth Circuit Finds That Misclassified Employees Are Eligible for Federally Regulated Employee Benefits*, 111 Harv. L. Rev. 609 (1997).

[164] *See* §423(b). Employee stock purchase plans generally must be made available to all employees other than those whose customary employment is for not more than 20 hours per week or five months per year.

[165] *Vizcaino v. Microsoft Corp.*, 1994 U.S. Dist. LEXIS 21038 (W.D. Wash. 1994).

[166] 1994 U.S. Dist. LEXIS 21039.

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c. The Ninth Circuit

On appeal, a three-judge panel of the Ninth Circuit reversed the district court[167] as to the SPP and the ESPP in *Vizcaino I*. The Ninth Circuit granted Microsoft's request for rehearing en banc.[168] In *Vizcaino II*, the full Ninth Circuit upheld the three-judge panel but widely divergent views were expressed in two concurring opinions.[169] The majority opinion authored by Justice Fernandez held in the plaintiffs' favor with regard to the ESPP but remanded the issue of the SPP to the plan's administrative committee. Justice Fletcher agreed with the majority as to the ESPP but disagreed with its decision to remand the SPP eligibility determination. Justice O'Scanlain agreed with the majority's decision to remand the SPP but dissented as to the ESPP. Microsoft appealed the en banc decision of the Ninth Circuit to the U.S. Supreme Court. The Supreme Court denied certiorari, and the matter went back to the district court.

Comment: The remand of the §401(k) plan to the plan administrative committee was a significant turning point in the case, and it contains some important lessons for practitioners in the fundamentals of plan design if the goal is to cover less than all of an employer's common law employees. The Microsoft §401(k) plan provided that, for plan eligibility purposes, the term "employee" was defined to include "any common law employee who receives remuneration for personal services rendered to the Employer and who is on the United States payroll of the Employer." This provision proved to be something of a double-edged sword for Microsoft. Being on the payroll meant that the worker was subject to employment taxes and wage withholding. Because elective deferrals under a §401(k) plan are withheld from pay, only individuals on the payroll were eligible to make §401(k) deferrals. Payment of employment taxes under this circumstance thereby implied that the worker was a common law employee. And once the worker was reclassified as a common law employee for employment tax purposes, it was difficult to argue that he or she should not also be a common law employee for §401(k) purposes. The plan also contained language giving the plan administrative committee discretion to interpret the plan such that judicial review would be under the arbitrary and capricious standard.[170] The §401(k) plan's definition of employee is susceptible to at least two interpretations, one favorable to the plaintiff and the other favorable to Microsoft. The plaintiffs claimed that the reference to the U.S. payroll is merely a geographic restriction limiting participation to U.S. employees. Alternatively, the plaintiffs urged that, even if valid, the defense should be rejected as being waived and that the court should consider only the evidence before the committee when it made its initial findings that the plaintiffs were not eligible. Microsoft did not advance the U.S. payroll argument until the matter was before the appellate court. Microsoft claimed that the restriction was intended to limit participation to those common law employees who were paid out of the Microsoft payroll budget. The magistrate determined that the court's review should be *de novo* and that it should be limited to evidence before the administrator during its initial review. The magistrate applied the doctrine of *contra proferentum* and held in the plaintiff's favor. The district court disagreed holding that the *contra proferentum* doctrine applied only where the intention of the parties is ambiguous. The Ninth Circuit held that the exclusion of the plaintiffs was arbitrary and capricious because the committee was mistaken as to the plaintiffs' true employment status. It thereupon remanded the determination to the plan administrative committee; the administrative committee denied both the remanded request for benefits and the subsequent appeal; and the case later settled. So, the court never had to decide whether the U.S. payroll argument was timely raised.

d. The Plaintiff Class

On remand, the district court adopted a definition of the plaintiff class that excluded claimants who were not either reclassified in connection with the employment tax audit or transferred to staffing firms.[171] In *Vizcaino III*, the Ninth Circuit reversed and reinstated the class as originally certified, i.e., those freelancers who were hired as regular employees of Microsoft and those who were transferred to temporary leasing companies.[172] The latter were not on the U.S. payroll, so their SPP eligibility presumably ended with their transfer. But did it? Microsoft appears to have assumed that a worker retained through a leasing company is not a common law employee. But if a preponderance of the *Darden* factors results in employee status, then the transferred employees might still be employees.

The ESPP is another matter. If the transferred employees continued to be common law employees of Microsoft, then they continue to be eligible to participate in the ESPP. After the original class was reinstated, any reclassified or transferred employee was treated as an eligible common law employee. The issue of the scope of the class of plaintiffs in the *Microsoft* case is instructive. Temporary employees who were not reclassified in connection with the IRS audit nonetheless had a claim for common law status. Accordingly, the class of plaintiffs is larger than the class of individuals affected by the IRS settlement. Moreover, if the workers transferred to temporary employment agencies were still common law employees, then the 1990 changes made by Microsoft as a part of its settlement with the IRS did not end their potential liability going forward. Similarly, workers hired through temporary employment agencies after the IRS settlement will have claims for benefits even though they were never affected by the settlement. It was this issue that motivated Microsoft to attempt to limit the size of the class.

e. The Settlement

On March 21, 2001, the district court entered an order approving a settlement agreement that had been filed on December 12, 2000. Under the agreement, Microsoft agreed to pay

[167] *Vizcaino v. Microsoft Corp.*, 97 F.3d 1187, 20 EBC 1873 (9th Cir. 1996) (Trott, J., dissenting).

[168] 105 F.3d 1334 (9th Cir. 1997).

[169] *Vizcaino v. Microsoft Corp.*, 120 F.3d 1006, 21 EBC 1273 (9th Cir. 1997), modifying 97 F.3d 1187 (9th Cir. 1996), cert. denied, 522 U.S. 1098 (1998).

[170] *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989) (language of termination pay plan did not support use of arbitrary and capricious standard of review because plan provided no discretion to plan administrator).

[171] *Vizcaino v. Microsoft Corp.*, 22 EBC 1777 (W.D. Wash. 1998).

[172] *Vizcaino v. Microsoft Corp.*, 173 F.3d 713, 23 EBC 1209 (9th Cir. 1999).

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$96.9 million into a fund established to compensate aggrieved workers and to pay attorneys' fees. Based on an earlier press release announcing the settlement proposal, between 8,000 and 12,000 class members were affected.[173] Although not made explicit in the settlement agreement, the manner in which the award is apportioned among the members of the plaintiff class appears to be calculated entirely with reference to the ESPP. Moreover, the settlement agreement also appears to have adopted a middle ground between the positions advanced by the parties before the mediator appointed by the district court to resolve the ESPP damage issue. The plaintiffs insisted on receiving the full value of the appreciation in Microsoft stock, from the date on which the stock would have been purchased but for the misclassification to the present. Microsoft wanted to limit its damages to the dollar-value of the discount. Under the settlement, the parties made some assumptions about the percentages of compensation that the excluded workers might have elected to invest in the ESPP based on the experience of the company's regular workers, and they also agreed on an average holding period of about a year. There also was a special rule applied to recent deemed stock purchases (where the stock has since declined in value) that gives the worker the benefit of the statutory discount.

This case, and its settlement, offers some valuable lessons to plan sponsors and practitioners:

• While the initial complaint covered a wide range of ERISA-covered pension and welfare plans, Microsoft was able to prevail (in the case of the welfare and fringe benefit plans) or appears to have prevailed (in the case of the SPP plan) on these claims. The problem arose only as a result of the discounted employee stock option plan under §423 that requires participation by virtually all employees as opposed to some sort of nondiscriminatory class of employees. Although not clearly spelled out in the proposed settlement agreement, it appears that the settlement was made principally, if not entirely, with respect to the ESPP. Given the numbers of workers employed by Microsoft, the ESPP may well have covered a nondiscriminatory classification of employees. But ESPP's eligibility provision was prescribed by the I.R.C. to include, essentially, *all* employees, and not just a nondiscriminatory class of employees. This led the Ninth Circuit to find that the freelancers should have been included based on applicable state law once they established their status as employees under a *Darden*-type test.

• Although the matter was not ultimately litigated, the case also suggests that the exclusion of a class of workers based on the fact that they were paid from accounts receivable rather than from Microsoft's regular U.S. payroll is a viable approach. (An IRS Technical Advice Memorandum that sanctions this approach is discussed at III.B.4.) The *Firestone* language in the plan giving the plan administrative committee the benefit of the arbitrary and capricious standard of review likely played a part in the settlement. Without this provision, plaintiffs' counsel is likely to have more aggressively pursued the claims under the §401(k) plan. (See III.B.5.d. for a related discussion involving benefit waivers.)

4. Retroactive Reclassification of Workers

The *Microsoft* case highlighted the risks of retroactive worker reclassification. An employer's decision to classify a worker as an independent contractor rather than an employee, whether made inadvertently or with the utmost good faith and attention, is not binding on, and can be overturned by, a court or administrative agency. To furnish a hedge against this exposure, employers and their advisors have attempted to fashion plan provisions that bar retroactive participation where a worker is reclassified. These provisions have come to be known as Microsoft inoculation provisions. The following is an example of a definition of an eligible employee that contains a typical Microsoft inoculation provision:

> "Eligible Employee" means any Employee who is employed by a Participating Employer other than (i) an Employee covered by a collective bargaining agreement as to which retirement benefits were the subject of good faith bargaining, unless such agreement expressly provides for participation in the Plan, (ii) a "leased employee" within the meaning of §414(n), or (iii) an individual who is not characterized or treated by the Participating Employer as a common law employee of a Participating Employer. In the event an individual described in (iii) above is reclassified or deemed to be reclassified as a common law employee of a Participating Employer who meets the definition of an Eligible Employee, the individual shall be eligible to participate in the Plan as of the actual date of such reclassification (to the extent such individual otherwise qualifies as an Eligible Employee hereunder). If the effective date of any such reclassification is prior to the actual date of such reclassification, in no event shall the reclassified individual be eligible to participate in the Plan retroactively to the effective date of such reclassification.[174]

a. 1999 Unreleased TAM

The IRS initially balked at approving determination letter requests for plans that included Microsoft inoculation provisions. They were concerned that these provisions failed the definite written program requirement,[175] but they have since relented. An unreleased technical advice memorandum dated July 28, 1999 (the "1999 TAM")[176] suggests that a retirement plan document may exclude employees not reported on a company's payroll as common law employees, even if a court or administrative agency determines that such individuals are common law employees and not independent contractors. The issue presented in the 1999 TAM was whether workers could be excluded

[173] *Microsoft to Pay $97 Million to Settle Temporary Workers' Class Action Lawsuits*, 27 BNA Pen. & Ben. Rptr. 3096 (Dec. 19, 2000).

[174] This provision is excerpted from a sample §401(k) plan document contained in the Worksheets of 358 T.M., *Section 401(k) Cash or Deferred Arrangements.*

[175] Reg. §1.401-1(a)(2) provides in pertinent part that "a qualified pension, profit-sharing, or stock bonus plan is a definite written program and arrangement which is communicated to employees and which is established and maintained by an employer."

[176] The 1999 TAM is reproduced in the Worksheets of this Portfolio.

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from plan participation in two plans on facts similar to the Microsoft §401(k) plan.

Specifically, the 1999 TAM addressed the following issues:

- Whether plans may exclude from participation employees who are either (1) not reported on the payroll records of the affiliated companies as common law employees (even if a court or administrative agency determines that such individuals are common law employees and not independent contractors) or (2) are identified by either a specific job code or work status code on the employer's payroll records, and still satisfy the requirements of §401(a) and Reg. §1.410(a)-3(d).

- Whether plan eligibility and cashout requirements cause such plans to satisfy the requirement that a plan must be a definite written program.

Section 410(a) provides, in general, that a plan may not postpone plan eligibility with respect to an eligible employee beyond the date on which the employee attains age 21 and completes one year of service. The IRS cites Reg. §1.410(a)-3(d) in the 1999 TAM, which states:

> Section 410(a) and §1.410(a)-4 relate solely to age and service conditions and do not preclude a plan from establishing conditions, other than conditions relating to age and service, which must be satisfied by plan participants. *For example, such provisions would not preclude a qualified plan from requiring, as a condition of participation, that an employee be employed in a specific job classification.* (Emphasis added.)

The regulations also make it clear that plan provisions may be treated as imposing age and service conditions even though age and service are not specifically mentioned. Reg. §1.410(a)-3(e)(2) *Ex.* 1 describes such an indirect service requirement: A corporation is divided into two divisions. In order to work in division two, an employee must first have been employed in division one for five years. Such a provision constitutes an indirect service requirement because it has the effect of requiring five years of service.

The IRS first addressed the application of §410(a). Observing that even an employer acting in good faith might have difficulty distinguishing between an employee and an independent contractor, the IRS pointed out that §401(a) does not require automatic participation where an independent contractor is reclassified. Rather, the plan terms should be examined to determine whether or not the re-characterized workers participate in the plan.[177] The IRS concluded that the particular payroll code-based exclusions described in the TAM did not violate §410(a) even though a determination of eligibility in each case required an examination of facts external to the plan document.

The IRS next turned its attention to Reg. §1.401-1(a)(2), which requires that a plan be a definite written program and arrangement which is communicated to employees. The IRS cited Rev. Rul. 74-466 as an example of a plan that failed the definitely written program requirement. There, the eligibility provisions of the plan excluded non-salaried employees unless such employees satisfied alternative eligibility requirements approved by the trustees. The distinction between the ruling in the revenue ruling and the unreleased 1999 TAM is not immediately obvious. In each case, one must look outside the plan document to determine who is eligible to participate in the plan. In the revenue ruling, however, the external inquiry was based on trustee discretion while the external inquiry in the 1999 TAM was objective.

But might the employer also exercise the same sort of objectionable discretion in assigning an employee to a particular job classification? The unreleased 1999 TAM attempts to answer this question. By virtue of the definite written program requirement, the terms of a plan cannot leave the determination of which employees are covered to the plan sponsor's discretion. The selection criteria must be objective. A plan sponsor that randomly assigned employees to certain payroll codes would not be able to take any comfort from the IRS's findings under the 1999 TAM. The IRS fashioned a rule that plan sponsors could use to determine whether its exclusionary categories pass muster. It said:

> We believe the appropriate inquiry as to whether or not a particular category is acceptable is whether, given the particular facts of the employer and the plan provision, is it clear whether or not a particular employee is or is not in the plan. That is, is it clearly understood by the employees, the plan administrator, and the plan fiduciaries when they examine all the facts, which employees are covered by the plan and which employees are excluded. If this question can be answered in the affirmative, then the plan passes the definite written program requirement. Whether the question is being asked as to the present situation or on a retrospective basis, the test is the same.[178]

The 1999 TAM does not address compliance with §410(b) (relating to plan coverage). That section describes two alternatives for passing the minimum coverage requirements: the ratio percentage test under §410(b)(1)(A) and §410(b)(1)(B) and the average benefit percentage test under §410(b)(2). Under Reg. §1.410(b)-4(b), the average benefit percentage test is further subject to reasonable classification requirement. Reasonable classification requires an objective business purpose or criteria. Any enumeration of participants by name or other criteria having substantially the same effect as enumeration by name is not considered a reasonable classification. The ratio percentage test has no parallel requirement. So it is possible to satisfy §410(b) under the ratio percentage test even if the excluded class consists of a list of employees designated by name with no objective business purpose.

The 1999 TAM provides that the definite written program standard is complied with so long as the classification is not ambiguous. According to the unreleased 1999 TAM, this standard is satisfied if an employee can tell whether he or she is entitled to participate by reading the plan document, but it goes on to state that there "may be … categories that leave the employer arbitrary and unbridled discretion and that are based on *no independent business reason* such that the category does not

[177] 1999 TAM.

[178] 1999 TAM.

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satisfy the definite written program requirement." (Emphasis added.) If plan eligibly is based on an employee's name appearing on a list,[179] and if the employer can choose to designate or not designate an employee as a participant at will, then the arrangement will not satisfy §410(a). This has the effect of imposing an independent business reason requirement under §401(a). What is not yet clear is whether an independent business reason and a business purpose are the same thing.

The TAM also addresses the treatment of perma-temps. A perma-temp is a worker who is typically classified as "temporary" but is assigned to a classification of employees that is not benefits-eligible even though he or she performs the same jobs as, and works side-by-side with, regular employees over long periods of time. Under the TAM, it is theoretically possible to exclude perma-temps so long as the plan satisfies the definitely determinable standard. By way of example, assuming that there are no impermissible service-related restrictions, might a plan that validly excludes special service employees also provide that an individual hired as such will be permanently excluded from participation even if he or she is later transferred to the regular employee status? The answer depends on the manner in which the courts and the ERISA agencies ultimately interpret the definitely determinable standard.

b. 2000 Unreleased TAM

Plan sponsors took comfort in the 1999 TAM's narrow holding — i.e., that plan provisions excluding employees by group or class would not prevent the issuance of a favorable determination letter. But this comfort proved to be short lived. A subsequent, unreleased TAM issued November 28, 2000 (2000 TAM)[180] instructed reviewers to add a caveat to any determination letter involving an exclusionary classification to the effect that the determination letter may not be relied upon to establish compliance with §410. The caveat reads:

> This determination letter may not be relied upon with respect to whether the subject plan's exclusion classifications violate the minimum age or service requirements of §410 of the Code by indirectly imposing an impermissible age or service requirement.

This change in no way affects a plan sponsor's ability to obtain a favorable determination letter for a plan that includes an exclusionary classification, but it deprives the plan sponsor of the §7805 protections and preserves intact the IRS's ability to contest the provision on audit.

The 2000 TAM involves a plan maintained by a tax-exempt hospital that excluded from plan coverage the following employee groups:

> • *Group A Employees.* These employees are described as being members of the supplemental and substitute work force of the Employer, as distinguished from regular, full-time and part-time employees. Group A is subdivided into three sub-classes designated as Class X Employees (on-call employees), Class Y Employees (substitute employees), and Class Z Employees (irregular or intermittent employees).
>
> • *Group B Employees.* Employees in this class are described as generally used to fill employment positions that are difficult to staff for a short period of time and often involve a higher rate of pay than would be paid to a regular employee in the same position.

In its analysis, the IRS also relies on an earlier field directive relating to the exclusion of part-time employees.[181] After reviewing the authorities, the IRS concluded that the determination of whether the exclusionary classes are acceptable under §410 requires an examination of all of the surrounding facts and circumstances that it was not prepared to undertake. According to the IRS:

> Such an inquiry is time consuming, both for the Service as well as the taxpayer, particularly at the determination letter stage. Further, in this case we do not have the necessary demographic and other relevant facts. For these [reasons], the question of whether a particular plan exclusion classification violates the minimum service requirements of §410 of the Code, by indirectly imposing an impermissible service requirement, should be decided when the plan is examined by the Service and not in connection with the issuance of a determination letter.

Like private letter rulings, technical advice memoranda have no value as precedent. Nonetheless, the 2000 TAM is persuasive simply because it is so well reasoned. Unlike §410(b), §410(a) has a counterpart in ERISA §202(a)(1). So its reasoning should apply with equal force where ERISA Title I claims are in issue. Due in large part to the nature of its mission, the DOL might be expected to be hostile to coverage exclusions. So it remains to be seen whether the DOL will embrace the TAM's reasoning or agree with its approach. The 2000 TAM gives the DOL a great deal of latitude on this score.

Comment: While bound to disappoint plan sponsors and practitioners, the approach taken in the 2000 TAM has some merit. If reliance remained the norm, the IRS could find its enforcement efforts compromised by the determination letter process. Courts also might take the issuance of a determination letter as evidence that the IRS has somehow given its blessing to an exclusionary arrangement, and plan sponsors would inevitably try to use the determination letter as a shield in a DOL investigation. The holding of the unreleased 2000 TAM may be too broad, however, in that it applies to *all* exclusionary classifications. This means that a determination letter issued to the plan that distinguishes between hourly and salaried employees, for example, would include a caveat even though Reg. §1.410(b)-4(b) explicitly sanctions such an arrangement. Should a plan sponsor really be required to defend this sort of exclusionary classification on audit?

c. The Unresolved Issues

The unreleased 1999 and 2000 TAMs deal with worker reclassification and exclusionary classifications, but these issues are a subset of a larger, more daunting question: Can a

[179] Such a plan would need to pass the coverage requirements of §410(b) based on the ratio percentage test set out in Reg. §1.410(b)-2(b)(2). Reg. §1.410(b)-2(b)(3) and §1.410(b)-4(b) (the average benefits test) prohibit this approach.

[180] The 2000 TAM is reproduced in the Worksheets of this Portfolio.

[181] *See* IV.F.1.

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plan sponsor treat two employees — each with substantially the same skills, duties, hours, and job tenure — differently for benefits purposes? By way of example, there are some industries that for budgetary purposes routinely hire employees as either "benefits-eligible" or "not-benefits-eligible" where their duties are otherwise indistinguishable. Whether a plan of this sort will pass muster under §410(a) depends on whether a budgetary purpose rises to the level of an independent business reason/business purpose. And even if the IRS determines that there are sufficient grounds to support the issuance of a determination letter, there is no guarantee that a court or the DOL will honor this assessment when presented with a claim by or on behalf of excluded employees under Title I of ERISA. Like the I.R.C., ERISA nowhere mandates plan coverage for all employees, but once an employee becomes a part of a class of employees eligible for plan participation ERISA dictates the maximum period of time that participation can be delayed. Establishing the basic eligibility categories is a settlor function. But if the criteria used to distinguish between an eligible and ineligible worker are vague, ambiguous or difficult to apply, then excluded employees are likely to claim that the plan sponsor, acting in its fiduciary capacity, incorrectly applied the criteria thereby depriving them of benefits.

5. Exclusion of Ineligible Classes of Employees

The *Microsoft* case invites the question: Does ERISA require a tax-qualified plan to cover all employees of an employer, or may the employer carve out classes of employees (e.g., leased employees)? Or, to put the question another way: Can an employer maintain a plan that covers employees wearing blue badges but exclude those wearing orange badges assuming no other distinguishing features (but also assuming no other actionable discrimination, such as under Title VII of the Civil Rights Act)? ERISA §404(a)(1)(A)(I) sets forth the exclusive benefit rule under which a plan must be organized and administered solely in the interests of participants and beneficiaries. Section §401(a) contains its own exclusive benefit rule that applies to tax-qualified plans. Both exclusive benefit rules are directed toward, and are intended to protect the interests of, employees, but neither rule mandates coverage of *all* employees of a plan sponsor. Plan sponsors are generally free, within limits, to designate eligible classes of employees.[182]

ERISA leaves it to the plan sponsor, in its settlor capacity, to determine which employees or classes of employees will be covered under a plan. However, once an employee is determined to be within an eligible class, ERISA §202 generally requires that participation not be delayed beyond age 21 and one year of service.[183] ERISA §502(a)(3) gives an improperly excluded employee the right to sue for benefits, and if the exclusion is sufficiently egregious, ERISA fiduciary standards may be implicated.[184] But the case law in this area has evolved in such a way as to limit damages available to plan participants and beneficiaries. See VII.A., and VII.B., for a discussion of the fiduciary implications of worker misclassification.

An employer's ability to exclude classes of employees from coverage under a tax-qualified plan is limited by the §410(b) provisions that require plan coverage to be nondiscriminatory. Regulations issued under §410(b) sanction the exclusion of employees from plan participation under either the ratio test or the average benefits test.[185] The former is purely mechanical; the latter requires a demonstration of reasonableness.[186] The I.R.C. contains a further requirement that a plan be a definite written program and arrangement which is communicated to the employees.[187] This definite written program requirement precludes plan sponsors from exercising too much discretion over the assignment of an employee to an included or excluded class.[188] The I.R.C. contains no private right of action on the part of excluded employees; rather, the sanction is plan disqualification if the exclusion results in a violation of the coverage rules of §410(b) or, in the case of a defined benefit plan, §401(a)(26).

a. Cases Inferring a Private Right of Action

The following cases infer a private right of action.

(1) Crouch v. Mo-Kan Iron Workers Welfare Fund

Crouch worked as a secretary in the office of a local union. The union was the sponsor of two ERISA-covered employee benefit plans: a welfare plan and a pension plan. The plans contained identical eligibility provisions under which the employer included those entities required to make contributions under the terms of an applicable collective bargaining agreement, and the term "employee" was defined as a person who was an employee of an employer. Each plan contained the provisions requiring it to qualify for approval by the U.S. Treasury Department, Internal Revenue Service and the Department of Labor, and that all questions pertaining to the validity, construction and administration would be determined in accordance with ERISA.[189] Although not sanctioned by the underlying collective bargaining agreements or the terms of the plans, the local union made contributions to both plans on behalf of the union officers but not on behalf of Crouch.

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[182] *Shaw v. Delta Airlines, Inc.*, 463 U.S. 85, 4 EBC 1593 (1983) ("ERISA does not mandate that employers provide any particular benefits, and does not itself proscribe discrimination in the provision of employee benefits"). 463 U.S. at 91.

[183] I.R.C. §410(a)(1)(A) and ERISA §202(a)(1)(A). Plans that are maintained by educational organizations (as defined in §170(b)(1)(A)(ii)) and that require not more than one year of service for eligibility purposes can exclude individuals who have not attained age 26, instead of age 21. I.R.C. §410(a)(1)(B)(ii) and ERISA §202(a)(1)(B)(ii).

[184] *See generally Varity Corp. v. Howe*, 516 U.S. 489, 19 EBC 2761 (1996) (holding employees could seek individual relief under ERISA §502(a)(3) based upon claim that employer intentionally misrepresented that their benefits would remain secure if they transferred into employer's newly established entity).

[185] Reg. §1.410(b)-2.

[186] Reg. §1.410(b)-4(b). A classification is deemed reasonable under the regulations "if and only if, based on all the facts and circumstances, the classification is reasonable and is established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications generally include specified job categories, nature of compensation (i.e., salaried or hourly), geographic location, and similar bona fide business criteria. An enumeration of employees by name or other specific criteria having substantially the same effect as an enumeration by name is not considered a reasonable classification."

[187] Reg. §1.401-1(a)(2).

[188] *See* 1999 TAM, reprinted in the Worksheets of this Portfolio, and discussed in III.B.4.a.

[189] 740 F.2d 805, 5 EBC 1971 (10th Cir. 1984). *See Landry v. Ga. Gulf Corp.*, 33 EBC 1117 (5th Cir. 2004) (tax-exempt status of employee benefit plan is not related to determination of whether worker is common law employee).

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Finding that welfare plans are exempt from ERISA's participation, vesting, and funding requirements, the court held that the union's failure to cover Crouch was not arbitrary, capricious or contrary to the plan. But the court reached the opposite conclusion with regard to the pension plan. It reasoned that the I.R.C.'s participation and vesting rules require the inclusion of the plaintiff. While this result might be warranted on the unusual facts before the court, it is deficient in at least three respects: first, it is entirely likely that none of the union personnel — including the plaintiff — were entitled to coverage under the terms of the plan; second, even if coverage were warranted, there is no showing that the plan would have failed coverage testing if the plaintiff were excluded; and third, by looking to the substantive provisions of the I.R.C. for a remedy, the court created a private right of action for violations of the tax-qualification rules of the I.R.C. that has no statutory support.

(2) Renda v. Adam Medrum and Anderson Co.

In 1955, Renda applied for and was hired to fill a position in the jewelry department of a large department store. She was paid through the store and was required to observe the store's dress code. She even wore a store-provided nametag. Unbeknownst to Renda, however, all of the workers in the jewelry department were leased from a third party that also sublet space in the department store. In 1976, the store established a pension plan that covered only the common law employees of the department store. Following her retirement, Renda sought to receive benefits under the pension plan. There being no disputed facts, the matter came before the court on a motion for summary judgment. The court held that Renda was a common law employee of the department store, and as such was entitled to plan coverage but that this alone was not sufficient for recovery.[190] The court also required Renda to establish that she was entitled to coverage. Citing *Crouch* with approval, the court held that Renda's exclusion as a leased employee violated the I.R.C.'s minimum coverage rules. The remedy, according to the court, was to award Renda plan benefits.

b. Later Cases — No Private Right of Action

Although the nondiscrimination provisions of I.R.C. §410(b) have no counterpart in Title I of ERISA, both *Crouch* and *Renda* impose these requirements, thereby creating a private right of action. Other, more recent, cases have taken a different view. They include the following.

(1) Abraham v. Exxon Corp.

The Fifth Circuit had before it a claim for benefits under the Exxon pension plan. In *Abraham v. Exxon Corp.*,[191] plaintiffs were leased or special arrangement employees, who worked at Exxon facilities, reported to Exxon supervisors, carried Exxon business cards, and even played on the Exxon softball teams. Although the court did not reach the issue, these employees were probably common law employees of Exxon. Nevertheless, they were expressly excluded from participation under the terms of the plan. The plaintiffs claimed that their exclusion was discriminatory and contrary to the minimum participation rules of the I.R.C. The court rejected both claims.[192] In so holding, the court not only rejected *Renda* but also devoted a considerable amount of time explaining why *Renda* was wrongly decided. Its criticisms were:

(1) The court specifically refused to adopt a structural defect analysis that originated in the Ninth Circuit's Taft-Hartley jurisprudence. Under that approach, a pension plan is structurally deficient when it arbitrarily and unreasonably excludes large numbers of participants, thus failing to satisfy the sole and exclusive benefit of all employees requirement.[193] The argument under a structural defect analysis is that ERISA was intended for the exclusive benefit of employees and their beneficiaries, and if a plan does not cover a sufficiently large number of employees it must be found to violate the exclusive benefit rule. The court could find no basis in ERISA for this requirement. It also noted that plan design issues that affect coverage are settlor, and not fiduciary, functions. Accordingly, Exxon was not held to have violated its fiduciary duty when it excluded these employees.

(2) The court declined to hold, as did the *Renda* court, that violation of the minimum coverage rules of ERISA was actionable. Rather, the court held that the minimum age and service rules of ERISA §202 do not prevent an employer from discriminating against some groups of employees, including leased employees, so long as the discrimination is not age- or service-based.

(3) The court also refused to extend the reach of Reg. §1.410(b)-4(c)(3)(ii) (relating to factors that the IRS will consider in determining whether a classification that falls between the safe-harbor and non-safe harbor will be deemed to pass the nondiscriminatory classification prong of the average benefits test).[194] Here, the court's criticism was particularly harsh. It specifically rejected the *Renda* court's view that regulations such as these were "useful for extracting subtler shades of meaning necessary to paint a

[190] 806 F. Supp. 1071 (W.D.N.Y. 1992). In *Kolling v. Am. Power Conversion Corp.*, 347 F.3d 11, 31 EBC 1513 (1st Cir. 2003), the court rejected the plaintiff's reliance on *Renda* to support his claim that he was entitled to ESOP benefits because he qualified as a common law employee, concluding instead that, as long as an employee benefit plan does not discriminate based on age or length of service, nothing in ERISA requires a plan to extend benefits to every common law employee. The court noted that, as the plan definition of "employee of the employer" was not well defined, the plan's administrator, consistent with prior business practice, was entitled to limit participation only to those employees who received W-2s, thus excluding the plaintiff, who was considered an independent contractor by the plan administrator.

[191] 85 F.3d 1126, 20 EBC 1353 (5th Cir. 1996), aff'g 892 F. Supp. 807 (E.D. La. 1995).

[192] *Clark v. E. I. DuPont de Nemours & Co.*, 105 F.3d 646, 20 EBC 2308 (4th Cir. 1997), cert. denied, 520 U.S. 1259, 21 EBC 1208 (1997); *Bronk v. Mountain States Tel. & Tel., Inc.*, 140 F.3d 1335, 21 EBC 2862 (10th Cir. 1998), rev'g 943 F. Supp. 1317 (D. Colo. 1996).

[193] *Abraham*, 85 F.3d at 1129 (citing *Phillips v. Alaska Hotel and Rest. Employees Benefit Fund*, 944 F.2d 509, 515 (9th Cir. 1991), cert. denied, 504 U.S. 911 (1992).

[194] Included among the facts and circumstances relevant in determining whether a classification is nondiscriminatory are the following: (1) The underlying business reason for the classification; (2) the percentage of the employer's employees benefiting under the plan; (3) whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce; (4) the difference between the plan's ratio percentage and the employer's safe harbor percentage; and (5) the extent to which the plan's average benefit exceeds 70%.

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more detailed portrait of an individual's substantive rights under ERISA."[195]

(4) The court criticized *Renda's* reliance on *Crouch*. The court distinguished the pension plan in *Crouch* from the Exxon plan by observing that the *Crouch* plan had language requiring the plan to meet the requirements of ERISA while the latter did not.

Comment: The court's view in this regard is problematic. Many plans have language to the effect that the plan is intended to meet the requirements of ERISA and the I.R.C. or that the plan is to be interpreted in a manner consistent with these laws. The manner in which *Abraham* distinguished *Crouch* in this regard leaves open the possibility that the approach taken in *Crouch* has some continuing viability. This view ignores the fact that a plan can comply in all respects with ERISA and the I.R.C. and still not cover all employees. The better reasoned cases understand that ERISA does not prohibit discrimination in plan coverage.[196] Once an individual is or becomes a part of an eligible class of employees, his or her participation cannot be delayed beyond the periods prescribed.[197] The prohibitions against discrimination are I.R.C.-based, and the consequence of discrimination is potential plan disqualification. For its part, the I.R.C. requires nondiscriminatory coverage, not total coverage. Regulations issued under I.R.C. §410(b) clearly contemplate the exclusion of employees from participation calculated based on achieving a sufficient ratio of non-highly compensated employees to highly compensated employees (the ratio test) or based on a comparison of average benefit percentages (the average benefits test).[198] The former is purely mechanical while the latter requires a showing that the classification is reasonable.[199] Nonetheless, plan sponsors ought to be wary of plan provisions that require the plan to comply in all respects with the provisions of the I.R.C.

Similarly, in *Edes v. Verizon Communications, Inc.*,[200] the employer hired the plaintiffs to work in its office, but told the plaintiffs to sign on with an independent payroll agency that would issue their paychecks. Plaintiffs received no paychecks or benefits directly from the employer during the more than four years they worked in the office, but were otherwise treated like "regular," full-time employees. It appears from the description of the relationship between the parties that the plaintiffs were likely common law employees, although the court did not specifically reach this conclusion. The ERISA plan documents specified that only those employees who were "paid directly" by the employer would be eligible for benefits. Following the termination of their employment, the plaintiffs made claims for ERISA plan benefits, which the employer denied. The plaintiffs brought suit alleging violations of their rights under ERISA and state common law based on their misclassification as off-payroll employees ineligible to participate in the employer's ERISA plans and on the use of arbitrary eligibility criteria to exclude a disproportionate number of employees from plan participation. The district court granted the employer's motion to dismiss the complaint, and the First Circuit affirmed the determination. In deciding that an employer could exclude employees from participation in its benefit plans on the basis that the employees were paid by a third-party payroll agency, the court looked to the language of the plan and not whether the employees were common law employees.

(2) Capital Cities/ABC, Inc. v. Ratcliff

The facts in *Capital Cities/ABC, Inc. v. Ratcliff*[201] are similar to those in *Microsoft*. The case involved claims brought by newspaper carriers for the *Kansas City Star* newspaper for coverage under four separate ERISA plans made available to employees of the Kansas City Star Company, a wholly owned subsidiary of Capital Cities/ABC, Inc. Prior to 1977, the Star's newspapers were delivered by independent newspaper carriers who bought papers from the *Star* at a wholesale rate and then resold them at a retail rate to customers. It was undisputed that those carriers were independent contractors with complete control over the delivery of papers. In September 1977, shortly after Capital Cities acquired the *Star*, the *Star* notified its carriers that it planned to change its newspaper delivery system. It terminated all existing contracts with its carriers, and replaced them with agency agreements pursuant to which the carriers became delivery agents. These agreements specified that the carrier was an independent contractor and was not treated by the *Star* as an employee for federal, state, or local tax purposes. The agency agreements further specified that, as an independent contractor, the carrier would not receive, and has no claim to, any benefits or other compensation currently paid by the *Star* to its employees. The IRS subsequently conducted an examination and concluded that the carriers were common law employees of the *Star*. The carriers then formally requested ERISA benefits. The plan committee denied these requests, and the carriers filed suit. The district court granted summary judgment for Capital Cities.

On appeal, the Tenth Circuit, applying a *de novo* standard of review, sided with the district court. The Tenth Circuit offered two alternative grounds for its decision: first, citing its prior decision in *Boren v. Sw. Bell Tel. Co., Inc.*,[202] the court gave credence to the signed benefit waivers under the agency agreements. Second, the court determined that the carriers were excluded by the terms of the plans. Only one of the plans had a specific exclusion, however, under which eligible employees included "any staff or talent employee of the Company who is remunerated in U.S. currency, but shall not include … an individual who is hired by the Company pursuant to an employment agreement or personal services agreement if such agreement provides that such individual shall not be eligible to par-

[195] *Renda*, 806 F. Supp. at 1083.

[196] *See Shaw*, 463 U.S. at 91 (finding that ERISA does not mandate employers provide particular benefits and does not proscribe discrimination in provision of employee benefits). *See also Capital Cities/ABC v. Ratcliff*, 141 F.3d 1405, 22 EBC 1004 (10th Cir. 1998), aff'g 953 F. Supp. 1228 (D. Kan. 1997) (finding newspaper dealers working as independent contractors properly excluded from newspaper's pension plan even if common law employees).

[197] ERISA §202(a)(4) (generally, within six months or as of the first day of the next plan year, if earlier).

[198] Reg. §1.410(b)-2.

[199] Reg. §1.410(b)-4(b).

[200] 417 F.3d 133, 35 EBC 1577 (1st Cir. 2005).

[201] 141 F.3d 1405, 22 EBC 1004 (10th Cir. 1998), aff'g, 953 F. Supp. 1228 (D. Kan. 1997). *But see Baraschi v. Silverwear & Metropolitan Water v. Superior Court*, 29 EBC 2311 (S.D.N.Y. 2002) (employee may argue that she is common law employee and therefore entitled to participate in plan; motion for summary judgment dismissed).

[202] 933 F.2d 891 (10th Cir. 1991).

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ticipate in the Plan." So the court's holding appears correct as to this plan. But the remaining plans had no such exclusion. The court observed that the remaining plans offered little specific guidance on this score, and it ultimately relied on the existence of the waivers to deny participation to the carriers.

(3) Clark v. E. I. DuPont de Nemours & Co.

In an unpublished opinion, *Clark v. E. I. DuPont de Nemours & Co.*,[203] the Fourth Circuit had before it a claim by a worker employed under a leasing agreement to plan benefits under various ERISA-covered health, welfare, pension and retirement plans sponsored by DuPont. Clark was employed directly by DuPont from 1962 until 1970 as a structural steel detailer in the construction division of DuPont's plant in Martinsville, Virginia. DuPont terminated Clark in 1970 following the elimination of its construction division. Thereafter, DuPont supplemented a minimal construction staff with leased employees. Following his termination in 1970, Clark was employed by Carlton Construction Company from 1973 to 1975. Carlton Construction performed occasional contract work at DuPont's Martinsville plant. In 1975, Clark signed on with Belcan Engineering Group, Inc., a national employee-leasing firm that had an extensive employee leasing arrangement with DuPont at DuPont's Martinsville plant. The leasing agreement between Belcan and DuPont stated that the leased workers were to be considered employees of Belcan and not employees of DuPont. Clark participated in Belcan's health benefits program, and DuPont never made a contribution to any benefit plan for Clark. In 1993, DuPont terminated its contract with Belcan at its Martinsville plant. Clark then applied for unemployment benefits, listing Belcan as his former employer. Subsequently, Clark applied for coverage under the DuPont plans on the theory that he remained a DuPont employee after 1970 while he was nominally working for various contracting organizations, especially, Belcan. Affirming the district court's award of summary judgment for DuPont, the Fourth Circuit held that, even if Clark was a common law employee of DuPont (which the district court assumed to be the case for purposes of the summary judgment motion below), he was excluded from plan participation by the terms of the plans.

The *DuPont* court began by observing that, because the plans each provided the plan administrator with a deferential standard of review under *Firestone*,[204] the administrator's decision would be overturned only if it was arbitrary and capricious. It next turned to the plan eligibility provisions. Persons entitled to participate in the welfare benefit plans were defined in each plan as a full-time employee on the company's payroll. Because Clark was not on the payroll, the court had no difficulty upholding the plan sponsor's determination that Clark was not eligible to participate in these plans. DuPont's pension plans excluded individuals "who must be treated as employees of the Company for limited purposes under the 'leased employee' provisions of §414(n) of the Code." The court never reached the decision of whether Clark was a common law employee of DuPont or Belcan. The recitation in the leasing agreement between DuPont and Belcan that characterized Clark as a common law employee of Belcan does not dispose of the issue. Rather, it is only one among many factors to be considered in making that determination. If Clark was determined to be a common law employee of DuPont, then he could not have been a leased employee as that term is understood in §414(n). A §414(n) leased employee can never be a common law employee. On the other hand, a leased employee as that term is commonly used in industry parlance may or may not be the common law employee of the recipient. (See the description of lease employees in IV.A.)

With the benefit of hindsight, Clark probably made the wrong argument. Clark claimed that as a leased employee he should be included in the plan because the plan was required to include leased employees in order to secure beneficial tax treatment. This is similar to the arguments accepted by both the *Crouch* and *Renda* courts under which the provisions of the I.R.C. are expanded to establish individual causes of action. The Fourth Circuit declined to draw any such inference and was unwilling to read ERISA as requiring that all participants be covered.[205] Clark might have been better off arguing that, based on the *Darden* factors, he was DuPont's common law employee; the DuPont pension plans only excluded lease employees that were not common law employees (i.e., leased employees under §414(n)); and he was therefore entitled to benefits.

(4) Bronk v. Mountain States Tel. & Tel., Inc.

In *Bronk v. Mountain States Tel. & Tel., Inc.*,[206] plaintiffs performed services between approximately January 1984 and June 1991 for Mountain States Telephone & Telegraph, Inc., d/b/a US WEST Communications, pursuant to leasing contracts between US West and various leasing companies. The leasing contracts provided that the leasing company was the "employer" of the leased workers and that all workers were to be considered solely the employees or agents of the leasing company. The workers were neither on US West's payroll nor in its official service records. The workers filed ERISA claims requesting the right to participate in pension and welfare plans maintained by US West. They claimed that they performed the "same or similar" functions as US West employees and were therefore entitled to participate in the pension and welfare plans. The district court rejected the workers' claims as to the welfare benefit plans; but, citing *Renda*, it concluded that regardless of the language of such plans, the minimum participation, vesting and funding requirements of ERISA mandated the inclusion of all common law employees. The Tenth Circuit reversed, holding that ERISA prohibits exclusions based on age and service only. It also rejected the district court's holding that

[203] 105 F.3d 646, 20 EBC 2308 (4th Cir. 1997), cert. denied, 520 U.S. 1259, 21 EBC 1208 (1997).

[204] 489 U.S. 101, 117–18, 10 EBC 1873 (1989).

[205] *Stanton v. Gulf Oil Corp.*, 792 F.2d 432, 434–35, 7 EBC 1873 (4th Cir. 1986) (elucidating mere fact of employment does not entitle employee to participation in a plan established by ERISA); *West v. Clarke Murphy, Jr., Self Employed Pension Plan*, 99 F.3d 166, 169 (4th Cir. 1996) (determining employee status under ERISA is determined not by the tax code but by the common law of agency); *Coleman v. Nationwide Life Ins. Co.*, 969 F.2d 54, 56–57, 15 EBC 1865 (4th Cir. 1992) (holding participant and beneficiary status defined only by the terms of the ERISA plan), cert. denied, 506 U.S. 1081, 16 EBC 1488 (1993); *Swearingen v. Honeywell & Dalesandro v. Int'l Paper*, 189 F. Supp. 2d 1189, 27 EBC 2471 (D. Kan. 2002) (employee's status as participant in plan is ambiguous due to transfer to different location).

[206] 140 F.3d 1335, 21 EBC 2862 (10th Cir. 1998), rev'g 943 F. Supp. 1317 (D. Colo. 1996).

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Treasury regulations can furnish plan participants with substantive rights.[207]

(5) Trombetta v. Cragin Fed. Bank for Sav. Employee Stock Ownership Plan

In *Trombetta v. Cragin Fed. Bank for Sav. Employee Stock Ownership Plan*,[208] Trombetta and the other plaintiffs worked for Cragin Bank for Savings as "loan originators." The district court found that they: (i) solicited, procured, prepared and submitted to Cragin mortgage loan applications; (ii) were free to determine their own schedules and devise their own prospecting and sales strategies; (iii) were not supervised to the same extent as the in-house loan agents; (iv) each had signed an agreement to the effect that he or she was an independent contractor for all purposes; (v) used their own skill, discretion and knowledge to carry out their jobs; and (vi) paid their own licensing and permit fees. While Cragin allowed loan originators to participate in certain of Cragin's employee benefits programs at their own expense, they were not covered under Cragin's tax-qualified employee stock ownership plan (or ESOP). The committee that administered the ESOP was given the exclusive responsibility and authority to control and manage its operation and administration, including the authority to interpret the ESOP. The ESOP also granted the committee the specific power to determine which Employees qualify to enter the Plan. Following the sale of Cragin to a third-party acquirer, the ESOP was terminated. Plaintiffs filed suit seeking to participate in the ESOP's distributions. The question before the court was whether the loan originators were common law employees and thereby eligible to participate in the ESOP. Applying the *Darden* factors, the plan committee concluded that the loan originators were not common law employees. Reviewing the committee's decision under the arbitrary and capricious standard, and also placing great weight on the agreement signed by the loan originators reciting that they were independent contractors, the court denied the plaintiff's claims.

c. Standing

There is nothing in ERISA or the I.R.C. that would prevent a plan sponsor from excluding certain employees of classes of employees so long as the exclusion is neither entirely arbitrary[209] nor based (directly or indirectly) on age or length of service. The excluded participants would not have standing under ERISA §502, nor would they have a claim for breach of fiduciary duty under ERISA §409 because the establishment of the excluded class is most likely a settlor,[210] not a fiduciary, function.[211]

The issue of standing arose in *Boren v. Sw. Bell Tel. Co., Inc.*[212] Boren worked for Southwestern Bell between 1952 and 1980 as an architectural supervisor. Boren entered into written contracts with Southwestern Bell whereby, for a specified fee, he would supervise construction of specific buildings. The terms of these contracts included the completion dates of the specific projects. From about 1962 until 1980, the contracts were for a fixed period of time with cancellation available to either party upon 10 days written notice. At other times no contract existed between the plaintiff and Southwestern Bell. The plaintiff's relationship with Southwestern Bell terminated on April 1, 1980.

Southwestern Bell sponsored an employee pension and welfare plan that covers all employees. Employees accrued retirement benefits under the pension plan based on their rate of pay and years of service with the company, and benefits were funded entirely by company contributions to the plan trust. The pension plan's administrative committee determined that Boren and others similarly situated were not employees of Southwestern Bell, but were independent contractors on retainer. As such, they were ineligible for plan participation. Boren filed a claim for pension benefits. The administrative committee denied the claim, and Boren filed suit. The district court agreed with the committee's determination that Boren was not an employee. In so holding, the court looked to ERISA §502(a)(1)(B), which allows a participant to bring a civil action. Noting that under ERISA §3(7) one must be an employee to be a participant, the court denied standing to Boren. The Tenth Circuit agreed.

d. Waivers

The *Microsoft* case (described in III.B.3.) focused the attention of plan sponsors, benefits practitioners and plaintiffs' lawyers on the effectiveness of benefit waivers. Although the agreements covering the Microsoft freelancers contained an express waiver of benefits, the Ninth Circuit refused to enforce the waivers because the waivers were based on a mutual misunderstanding of the workers' proper legal status.[213] And as common law employees, the workers claimed that they were entitled to participate in both the company's §401(k) plan and an employee stock purchase plan governed by §423.

The Microsoft §401(k) plan, which was referred to as the Employee Savings Plan or ESP, covered only workers who were "on the U.S. payroll." What is not clear is whether this phrase referred only to those workers who were paid under the company's regular payroll (in which case the reclassified workers who were paid through the company's accounts receivable department would be ineligible to participate) or whether it referred to workers who were paid remuneration for services in the United States (in which case the reclassified workers would be eligible). As discussed at length in III.B.3.c., the §401(k) plan contained language giving the plan sponsor broad discretion to interpret the plan under the standards enunciated in *Firestone*.[214] So it may have been difficult for the plaintiffs to prevail on this issue. But Microsoft raised the discretionary review issue for the first time on appeal, and it is not entirely clear whether this defense would have been available.

The *Microsoft* settlement agreement calculates damages solely with respect to the employee stock purchase plan under §423. One can interpret this to mean that the plaintiffs aban-

[207] *Bronk*, 140 F.3d at 1339 (citing *Abraham*, 85 F.3d at 1131).

[208] 102 F.3d 1435, 20 EBC 2265 (7th Cir. 1996).

[209] *See* II.B.4. (describing unreleased IRS Technical Advice Memorandum of July 28, 1999).

[210] *See Lockheed Corp. v. Spink*, 517 U.S. 882, 20 EBC 1257 (1996).

[211] *But see Vizcaino II*, 120 F.3d 1006, 21 EBC 1273 (9th Cir. 1997) (finding that Microsoft could "manipulate plan coverage" with impunity if excluded participants were summarily denied standing).

[212] 933 F.2d 891 (10th Cir. 1991).

[213] *Vizcaino II*, 120 F.3d 1006, 21 EBC 1273 (9th Cir. 1997) (holding that employment contracts that characterized workers as independent contractors were vitiated as a result of mutual mistake).

[214] *Firestone*, 489 U.S. at 117–18.

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doned the §401(k) claims altogether, or it might be that the parties factored the §401(k) exposure into the amounts paid with respect to the employee stock purchase plan claims. Although the Ninth Circuit refused to enforce the waiver, it never reached the question of whether the reclassified workers were entitled to participate in the §401(k) plan.

The *Microsoft* case progressed far enough to suggest an analytical framework within which benefit waiver claims can be considered. That framework invites us to consider the following:

> 1. Based on the *Darden* factors or other applicable multi-factor test, is the worker who executed the waiver an employee or an independent contractor? If the worker is determined to be an independent contractor, then the waiver will be unnecessary to exclude the worker from any plan that, by its terms, covers only common law employees. The inquiry should end there because the waiver is not implicated.
>
> 2. Again based on the *Darden* factors or other applicable multi-factor test, if the worker who executed the waiver is an employee, is he or she an employee of the plan sponsor? Or is the worker an employee of some other, non-control group-company, such as a staffing firm? If the worker is not the employee of the plan sponsor (or any company or entity within the controlled group of companies and related entities that includes the plan sponsor), then the waiver should again be unnecessary to exclude the worker from plan participation.
>
> 3. If the worker is determined to be an employee of the plan sponsor (or any company or entity within the controlled group of companies and related entities that includes the plan sponsor), then the next question is whether the waiver is effective — i.e., was it knowing and voluntary? If it was not, then one must consult the terms of the plan. Is the reclassified employee in a class of employees that are eligible to participate?
>
> 4. If the waiver is knowing and voluntary, the inquiry is not over. One must look to the terms of the plan and ask whether the reclassified employee, who has purportedly waived participation, is excluded from participation. At a minimum, a plan that excludes a worker under a valid waiver but does not have a plan provision permitting the exclusion will experience an operational failure. The model correction for an improperly excluded plan participant under Appendix A or B of EPCRS[215] is to restore plan contributions with earnings. And because ERISA §404(a)(1)(D) requires a fiduciary to operate a plan in accordance with its terms, the excluded worker may have a claim for benefits that is at least sufficient to withstand a motion for summary judgment.

The *Microsoft* case made it clear that the terms of the waiver agreement are not controlling. The agreements in that case referred to the workers as independent contractors, but the Ninth Circuit determined that they were common law employees. *Capital Cities*[216] took an approach that gives a great deal of deference to the terms of the waiver. But at least one of the plans at issue in that case explicitly excluded individuals hired by the company under an employment agreement that expressly excluded them from plan participation.

Borrowing from analogous ADEA waiver situations, the Second Circuit, in *Laniok v. Advisory Comm. of the Brainerd Mfg. Co. Pension Plan*,[217] adopted a totality of the circumstances test for benefit waivers. Laniok spent most of his working life as a tool and die maker. When the plant he worked at closed, Laniok was almost 57 years old. Although Laniok could have remained at the plant doing other work, he voluntarily retired and immediately began to receive a pension of about $300 per month. Soon after, he began looking for other work, Brainerd Manufacturing hired him, and then he was asked to sign a document titled "Waiver of Participation in the Brainerd Manufacturing Company Pension Trust."[218] Testimony indicated that Laniok signed the waiver reluctantly because he was afraid that if he refused he would lose his job. When Laniok retired from Brainerd in 1988, he submitted a claim for pension benefits to the plan administrator. His claim was denied on the basis of his signed waiver, his appeal to the Advisory Committee also was denied.

The district court held for the plan finding that Laniok's waiver was knowing and voluntary. The Second Circuit reversed and remanded. In so doing, it adopted a non-exhaustive list of factors that should be taken into consideration. These factors include:

> 1. the plaintiff's education and business experience;
>
> 2. the amount of time the plaintiff had possession of or access to the agreement before signing it;
>
> 3. the role of plaintiff in deciding the terms of the agreement;
>
> 4. the clarity of the agreement;
>
> 5. whether the plaintiff was represented by or consulted with an attorney, as well as whether an employer encouraged the employee to consult an attorney and whether the employee had a fair opportunity to do so; and
>
> 6. whether the consideration given in exchange for the waiver exceeds employee benefits to which the employee was already entitled by contract or law.

The plan provided that all employees were eligible to participate after a year of service. Laniok called this provision to the court's attention, but the court was unmoved. Based on its reading of the ERISA legislative history, the court determined that benefit waivers were entirely consistent with Congressional intent. The court was therefore willing to enforce the waiver so long as it was knowing and voluntary.

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[215] *See* Rev. Proc. 2021-30; 375 T.M., *EPCRS — Plan Correction and Disqualification.*

[216] *Capital Cities v. Ratcliff*, 141 F.3d 1405, 22 EBC 1004 (10th Cir. 1998), aff'g 953 F. Supp. 1228 (D. Kan. 1997).

[217] 935 F.2d 1360, 13 EBC 2377 (2d Cir. 1991).

[218] 935 F.2d at 1363. The waiver provided: "I, Peter Laniok, for personal and other reasons, desire not to participate in the Brainerd Manufacturing Pension Plan, and I hereby waive participation in that plan. This waiver is made voluntarily by me, and is not made as a condition to employment or retaining employment with Brainerd Manufacturing Company. This waiver is effective for the present year, 1978, and all subsequent years of my employment with the Company."

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Yak v. Bank Brussels Lambert[219] involved facts reminiscent of the *Microsoft* case. Yak entered into a consulting agreement with Bank Brussels Lambert under which she agreed to work as an independent contractor, and as such she would not be entitled to any employee benefits. When Yak ended her employment, she sought unemployment benefits. The Department of Labor sided with Yak, as did the IRS. Both agencies determined that Yak was an employee and not an independent contractor. Armed with these administrative decisions, Yak sought restitution from Bank Brussels Lambert for a variety of employee benefits. The lower court found that Yak unambiguously waived her right to employee benefits in the consulting agreement, and it dismissed Yak's claims.

In her appeal, the Second Circuit considered the benefits-waiver question. Yak first claimed the administrative findings of the DOL and IRS as to employee status should be accorded *res judicata* effect — i.e., the determination of employee status for DOL and IRS purposes conclusively established her employment status for all other purposes. The court rejected this argument. The court remanded the case to determine (i) which, if any, of the benefits sought by Yak were governed by ERISA, (ii) Yak's employment status, and (iii) the circumstances surrounding the execution of the release. An inquiry into the terms of the plan, and whether employees who have executed waivers are excluded from plan participation, is conspicuously absent from the Second Circuit's instructions to the lower court.

Comment: These cases highlight the value of the Microsoft inoculation language described in III.B.4.

The issue of the knowing and voluntary nature of waivers arises in other contexts as well. Often, plan participants are required to sign a waiver of claims as a condition of receiving benefits. While the context is different, the standards under which the waivers are tested are the same.

In *Morais v. Cent. Beverage Corp. Union Employees Supplemental Retirement Plan*,[220] the court found that the plaintiff's waiver was knowing and voluntary and reaffirmed the trial court's grant of summary judgment. The court observed that the plaintiff had outside legal assistance who advised him on the underlying settlement agreement; the plaintiff received $5,000 in consideration for signing the settlement agreement; and the agreement itself was simple, straightforward and the plaintiff had ample time to review it. Similarly, in *Rivera-Flores v. Bristol-Myers Squibb Caribbean*,[221] the court upheld summary judgment for the defendant against a plaintiff's attempt to invalidate a release. The court held that there was no genuine issue of fact as to whether the plaintiff's release was voluntarily and knowingly given in connection with the shutdown of certain of the defendant's operations. In support of its holding, the court said: there was no competent evidence that the plaintiff was disabled or incompetent at the time he signed the waiver; the plaintiff had 42 days to examine the agreement and discuss it with whomever he chose and ask questions before he signed it; and the language of the release was clear and unambiguous.

In *Smart v. Gillette Long-Term Disability Plan*,[222] the First Circuit endorsed and applied the six-factor test set out in *Laniok* to uphold the lower court's finding that a waiver of long-term disability coverage was knowing and voluntary. The plaintiff was an employee whose employment was being terminated by reason of a reduction-in-force. In connection with her termination, the plaintiff signed a severance agreement under which she waived the right to some but not all post-employment benefits. While an earlier version of the agreement excluded long-term disability coverage from the waiver, the final, signed version was silent on the matter. Sometime after leaving the employer, the plaintiff brought a claim for long-term disability benefits. The court determined that the plaintiff was well educated and commercially sophisticated and that she had negotiated the specific terms of the severance agreement. According to the court, although the final version of the agreement differed from earlier versions of the agreement that expressly excluded long-term disability benefits, it was nonetheless clear. The plaintiff also had reviewed the severance agreement with an attorney of her choosing before she signed it.

C. Tax-Sheltered Annuity Arrangements

The phrases "403(b) plan," "tax-sheltered annuity arrangement," and "tax-deferred annuity" are used interchangeably to refer to those plans, arrangements, or programs that satisfy the requirements of and enjoy the tax benefits conferred by §403(b). Such arrangements generally are available to employees of hospitals, educational institutions, and other tax-exempt organizations,[223] and they come in two common variants. The first is limited to elective salary deferrals by employees, and the second includes some combination of elective salary deferrals, employer matching contributions, and discretionary employer contributions. Because these arrangements defer income to or beyond periods of covered employment, they are governed by ERISA unless specifically exempted.[224] 29 C.F.R. §2510.3-2(f) further exempts from ERISA coverage tax-sheltered annuity plans that have no employer contributions and with respect to which the employer's involvement is minimal — i.e., the employer's activities are limited to entering into the group annuity contract; obtaining, summarizing, and disseminating investment product information; collecting and remitting payroll reduction contributions; and maintaining records.[225]

Contributions made to tax-sheltered annuity arrangements for the account of eligible employees are excludible from the employee's federal gross income within certain limits. The favorable tax benefits conferred by §403(b)(1)(A) are available under annuity contracts purchased: (1) for an employee by an employer described in §501(c)(3) that is exempt from tax under §501(a); (2) for an employee who performs services for an educational organization described in §170(b)(1)(A)(ii) by an employer that is a state, a political subdivision of a state, or an agency or instrumentality of any one or more of the foregoing; or (3) for a minister described in §414(e)(5)(A) by the minister

[219] 252 F.3d 127, 26 EBC 1334 (2d Cir. 2001).
[220] 167 F.3d 709 (1st Cir. 1999).
[221] 112 F.3d 9, 12 n. 4 (1st Cir. 1997).
[222] 70 F.3d 173, 19 EBC 2580 (1st Cir. 1995).

[223] See 388 T.M., *Section 403(b) Arrangements*, for a comprehensive discussion of these arrangements.
[224] ERISA §4 (i.e., government and church plans).
[225] Compliance with the §403(b) Treasury Regulations issued in 2007 (T.D. 9340, 72 Fed. Reg. 41,127 (July 26, 2007)) generally should not remove employers from the safe harbor provided under 29 C.F.R. §2510.3-2(f). DOL FAB 2007-02 (DOL will analyze on a case-by-case basis whether an employer's means of satisfying responsibilities under the §403(b) regulations causes the plan to be covered under Title I of ERISA).

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or by an employer. The definition of employee for this purpose is determined under standard common law notions of employee status.[226] A worker may not be eligible to participate either because he or she is not an "employee" within the meaning of §403(b)(1) or because he or she is in an ineligible class of employees.

As is the case with tax-qualified pension, profit sharing, and stock bonus plans, there are both tax and benefit consequences when a worker is either improperly covered under, or improperly excluded from participation in, a tax-sheltered annuity arrangement. But unlike their tax-qualified counterparts, only certain violations of §403(b) can result in disqualification of the entire plan or arrangement. A violation of the I.R.C.'s nondiscrimination rules affects the entire plan.[227] Plans maintained by churches, however, are not affected.[228] In addition, plans maintained by state and local governments, do not have to meet the discrimination rules applicable to non-salary reduction agreements, other than the rules of §401(a)(17), the compensation limit.

The §403(b)(12) nondiscrimination rules differ depending on the nature of the contributions being tested. The requirements of §401(a)(4), §401(a)(5), §401(a)(17), §401(a)(26), §401(m), and §410(b) apply to contributions that are not made pursuant to a salary reduction agreement — i.e., employer contributions. Elective deferrals under a salary reduction agreement are subject to a universal availability rule under which all non-excludible employees of the organization must be able to make elective contributions of more than $200 per year. For this purpose, nonresident aliens described in §410(b)(3)(C), employees who are students performing services described in §3121(b)(10), and employees who normally work less than 20 hours per week are excludible. Where a tax-sheltered annuity arrangement violates the nondiscrimination requirements, the tax advantages are lost as to all participants.[229] The taint that accompanies the loss of §403(b) status also extends to any affected assets transferred to another retirement plan account (such as an individual retirement account). Where the violation at issue is based on some other §403(b) requirement that does not implicate the entire plan, the tax consequences of the misclassification are confined to the affected workers. In either case, the failure can be corrected under the Voluntary Correction Program (VCP) procedures of EPCRS.[230]

Note that §403(b)(5) provides for all of the contracts purchased for an employee by an employer to be treated as a single contract for purposes of §403(b). Thus, if a contract fails to satisfy any of the §403(b) requirements, not only that contract but also any other contract purchased for that individual by that employer would fail to be a contract that qualifies for tax deferral under §403(b). If a contract includes any amount that fails to satisfy the requirements of the final §403(b) regulations, then, except for special rules relating to vesting conditions and excess contributions under §415 or §402(g), that contract and any other contract purchased for that individual by that employer does not constitute a §403(b) contract. Further, if a contract is not established pursuant to a written plan, the contract does not satisfy §403(b). Thus, if an employer fails to have a written plan, any contract purchased by that employer would not be a §403(b) contract. Also, if an employer is not an eligible employer under §403(b), none of the contracts purchased by that employer is a §403(b) contract. However, under the regulations, any other operational failure that is solely within a specific contract generally will not adversely affect the contracts issued to other employees that qualify in form and operation with §403(b). Thus, for example, if an employee's elective deferrals under a contract, when aggregated with any other contract, plan, or arrangement of the employer for that employee during a calendar year, exceed the maximum deferral amount permitted under §402(g)(1)(A) and §403(b)(1)(E), the failure would adversely affect the contracts issued to the employee by that employer but would not adversely affect any other employee's contracts.[231]

If a worker who is not an employee is nonetheless covered under a tax-sheltered annuity arrangement, the tax benefits of the arrangement will not be available to the worker, and the amount of the worker's vested benefit will be taxed in the year of the contribution. Amounts distributed will not be eligible for rollover to an individual retirement account. Analytically, this result also can be reached by treating the worker as a participant with no includible compensation or §415 compensation on which benefits can be based. Prior to the enactment of EGTRRA, annual contributions on behalf of a participant were limited to the lesser of an exclusion allowance[232] or the limits that apply in the case of defined contribution plans under §415(c). EGTRRA eliminated the maximum exclusion amount prong leaving only the limits imposed under §415.[233] Both excludible compensation under §403(b)(3) and compensation under §415[234] require compensation as an employee. The worker would not, however, be counted for nondiscrimination testing purposes.

[226] Reg. §1.403(b)-2(b)(9), T.D. 9340, 72 Fed. Reg. 41,127 (July 26, 2007), generally effective for taxable years beginning after December 31, 2008. *See also* TAM 7904005 ("[e]very individual is an employee, for federal employment tax purposes, if under the usual common law rules the relationship between him and the person for whom he performs services is the legal relationship of employer and employee. Guides for determining the employer-employee relationship are found in three sections of the Employment Tax Regulations; namely, Reg. §31.3121(d)-1, §31.3306(i)-1, and §31.3401(c)-1").

[227] Reg. §1.403(b)-3(d)(1)(ii), T.D. 9340, generally effective for taxable years beginning after December 31, 2008.

[228] §403(b)(12).

[229] If a tax-sheltered annuity arrangement fails to satisfy the nondiscrimination rules (including a failure to operate the plan in accordance with its coverage provisions or a failure to operate the plan in a manner that satisfies the nondiscrimination rules), none of the contracts issued under the arrangement qualify as §403(b) contracts. Reg. §1.403(b)-3(d)(1)(ii).

[230] *See* Rev. Proc. 2021-30, Part V; 375 T.M., *EPCRS — Plan Correction and Disqualification.*

[231] Reg. §1.403(b)-3(d)(1).

[232] Former §403(b)(2). The so-called "maximum exclusion allowance" was an amount equal to the excess, if any, of (i) the amount determined by multiplying 20% of an employee's includible compensation (as defined in §403(b)(3)) by the number of years of service, over (ii) the aggregate of the amounts contributed by the employer for annuity contracts and excludible from the gross income of the employee for any prior taxable year.

[233] Pub. L. No. 107-16, §632(a)(2)(B).

[234] *See* Reg. §1.415(c)-2 and §1.415(c)-2(g)(1), as amended by T.D. 9319, 72 Fed. Reg. 16,878, effective for limitation years beginning on or after July 1, 2007 (or Reg. §1.415-2(d) for previous limitation years); Reg. §1.403(b)-2(b)(11), generally effective for taxable years beginning after December 31, 2008.

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Where the erroneously covered worker is an employee but is not a member of an eligible class of participants, the tax benefits of the tax-sheltered annuity arrangement are unavailable. As in the case of the covered non-employee, the participant's vested benefit is taxed in the year of receipt, and not eligible for rollover. But if the plan is retroactively amended to include the employee, then there is no violation.[235] Unlike the excluded non-employee, the employee that is not a member of an eligible class but is nonetheless covered under a tax-sheltered annuity arrangement is counted for nondiscrimination testing purposes. EPCRS no longer allows excess amounts to be retained in a §403(b) plan and credited against the participant's future §415 limits.[236]

If none of the I.R.C.'s nondiscrimination rules are implicated, then the result is likely to be an operational failure that if discovered within three years, or if otherwise insignificant, can be corrected under the EPCRS Self-Correction Program without the need to seek IRS approval or pay any compliance fees or sanctions.[237] If the operational failure is significant and is not timely discovered, then correction will require either a VCP filing (if correction is voluntary) or an Audit CAP submission (if the problem is discovered on audit). But if the failure involves §401(a)(4), §401(a)(26), or §410(b), the failure likely is a demographic failure[238] and correction will require IRS approval regardless of significance under VCP or Audit CAP.

EPCRS furnishes model correction methods where an improperly excluded employee fails to receive discretionary employer contributions or matching contributions or if he or she is not given the opportunity to make elective deferrals.[239] Where discretionary employer contributions are concerned, the plan sponsor must restore the missing contributions with earnings.[240] If the excluded employee should have been eligible to make elective deferrals, or to receive matching contributions, then the plan sponsor must make a qualified non-elective contribution to the plan on behalf of the employee that is equal to the greater of 3% of compensation or the maximum deferral percentage for which the employer provides a matching contribution that is at least as favorable as 100% of the elective deferral made by the employee (in the case of elective deferrals) or the matching contribution amount (in the case of matching contributions) for the employee's group (either highly compensated or non-highly compensated).[241]

Where an eligible employee is improperly excluded from participation in a tax-sheltered annuity arrangement, he or she will likely have a claim for benefits, and perhaps a claim for fiduciary breach, either under ERISA §502 or under state law where the arrangement is not covered by ERISA. The EPCRS model corrections are designed to put excluded participants in as good a position as they would have been had the failure not occurred. Adoption of the model correction should provide claimants with an acceptable remedy, particularly where the claim is governed by ERISA.[242] But if state law controls, additional punitive or other remedies might be available.

Example: Facts: Organization C is a state-chartered, nonprofit corporation that is exempt from tax under §501(c)(3). In 2010, C adopts a tax-sheltered annuity arrangement that allows participants to elect to defer up to 6% of compensation and provides a dollar-for-dollar matching contribution up to 4% of compensation. The plan also has a discretionary employer contribution feature. C maintains no other retirement plans. Although C's management intended the arrangement to benefit only C's regular full-time employees, the plan document furnished by insurance company T provides that all employees with a "year of service" (defined as 1,000 hours of service in a 12-month measuring period) are eligible to participate. C has only five highly compensated employees. All five are regular full-time employees. No other employees are highly compensated. All contributions are fully vested. C has a total of 110 employees, 50 of which are regular full-time employees. Another 45 employees work between 15 and 25 hours per week and they have paid vacation that is half of that provided to full-time employees. The remaining 15 employees work 10 hours per week or less, and they have no paid vacation. For the first two years of operation, the plan is operated in accordance with management's understanding of its terms rather than the terms of the plan document. In each year, the deferral percentages of the highly compensated and non-highly compensated employees were 5% and 3%, respectively, and the matching contribution percentages were 4% and 2%. C made a discretionary contribution of 2%. Shortly after the start of the plan's third year of operation, a newly hired HR manager determined that 35 employees were improperly excluded from plan participation and that, once the excluded employees were included for ACP testing purposes, the contribution percentage for the non-highly compensated employees fell to 1%.

Analysis: The plan fails the requirements of §403(b)(12)(A)(i) (with respect to the discretionary and matching contributions) and §403(b)(12)(A)(ii) (with respect to the availability of elective deferrals). The discretionary employer contributions violate §401(a)(4) and §410(b). Absent correction, participants have unreported income for the two years in issue because the contributions are vested, and C has failed to properly withhold, pay and remit employment taxes and income tax withholding amounts. With correction, the IRS will not pursue income inclusion for affected participants or liability for income or employment tax withholding or employment taxes on account of the failure.

[235] *See* Rev. Proc. 2021-30, §4.05.

[236] *Compare* Rev. Proc. 2003-44, §6.06(2)(b), *with* Rev. Proc. 2021-30, §6.06(1), §6.10. A contribution in excess of the limitation of §415(c) is not an excess amount or a §403(b) failure under EPCRS if the excess is maintained in a separate account in accordance with the rules in the regulations under §403(b) and §415; such separate account is considered to be a §403(c) annuity contract. Rev. Proc. 2021-30, §5.02(3).

[237] Rev. Proc. 2021-30, Part IV, *modifying and superseding* Rev. Proc. 2019-19. Rev. Proc. 2021-30, generally effective July 16, 2021, extends the correction period from two to three years.

[238] *See* Rev. Proc. 2021-30, §5.02(2)(c).

[239] *See* Rev. Proc. 2021-30, Appendix A, §.05.

[240] Rev. Proc. 2021-30, Appendix B, §2.02.

[241] Rev. Proc. 2021-30, Appendix A, §.05(6)(b), §.05(2)(c).

[242] *See, e.g.*, *Cage v. General Motors Defined Benefit Salaried Plan*, 98 F. Supp. 2d 803 (E.D. Mich. 1999) (dismissing plaintiff's civil claim for damages after plan sponsor made correction under VCR).

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Correction: Correction of the §403(b)(12)(A)(ii) violations using the EPCRS model corrections will require that nonhighly compensated employees who have been excluded for more than 3 months and less than 3 years will be provided with a QNEC equal to 25% of the missed deferrals or 1.5% of compensation for each year in issue. If eligible employees were excluded more than 2 years ago, the required contribution is 50% the missed deferrals. In addition, all excluded employees will be required to receive notice of the failure no later than 45 days after the date on which correct deferrals begin. Employer contributions totaling 2% of compensation will need to be made for all eligible excluded employees to make up for missed matching contributions. Correction of the §403(b)(12)(A)(i) violation will be made with the employer contributions for missed matching contributions and the discretionary contributions of 2% of compensation will need to be contributed for all excluded employees. (While reallocating account balances attributable to discretionary employer contributions may be an acceptable alternative depending on the facts and circumstances, it is not an approved correction method and could only be done with the filing of a VCP application.) All contributions must be adjusted for earnings through the date of correction.[243]

D. Nonqualified Plans of Deferred Compensation

Nonqualified plans of deferred compensation[244] are retirement plans that are not designed or intended to take advantage of the tax benefits accorded tax-qualified pension, profit sharing and stock bonus plans under the I.R.C.[245] Such plans can cover discriminatory classes of employees, can include forfeiture or bad boy clauses, and can furnish benefits that exceed the qualified plan compensation and benefits limits.

Generally, for tax years beginning on or after January 1, 2005, unless a nonqualified deferred compensation plan meets certain requirements under §409A[246] (i.e., restrictions on distribution, acceleration of benefits, funding and elections) at all times during a taxable year, all amounts deferred under the plan are includible in gross income to the extent they are not subject to a substantial risk of forfeiture and not previously included in gross income. If the requirements are not satisfied, in addition to income inclusion, interest at the underpayment rate plus 1% is imposed and the amount required to be included in income also is subject to a 20% additional tax. Also, amounts required to be included in income under §409A are treated as wages for income tax withholding, FICA, and FUTA tax purposes. Amounts deferred in taxable years beginning before January 1, 2005, and earnings on such amounts are subject to these rules if the plan under which the deferral is made is materially modified after October 3, 2004.

Section 409A is not limited to arrangements between an employer and an employee. For the application of §409A to arrangements between a service recipient and an independent contractor, see Reg. §1.409A-1(f)(2). For the application of §409A to arrangements between a partner and a partnership, see Notice 2005-1, Q&A-7 and T.D. 9321, 72 Fed. Reg. 19,234 (Apr. 17, 2004), §II.G (preamble).[247] Notice 2008-115[248] provides guidance to employers on their reporting and withholding requirements for calendar year 2008 and to service providers on their income tax reporting and payment requirements with respect to amounts includible in gross income under §409A in 2008 and remains in effect for subsequent calendar years until further guidance is issued. In December 2008, the IRS issued proposed regulations addressing the calculation of amounts includible in income under §409A(a) and related issues including the calculation of the additional taxes applicable to such income and reporting obligations.[249] Those regulations are proposed to be generally applicable for taxable years beginning on or after the issuance of final regulations. Before the applicability date of the final regulations, taxpayers may rely on Prop. Reg. §1.409A-4 only to the extent provided in further guidance. According to Notice 2008-115, taxpayers may rely on the proposed regulations concerning reporting and withholding requirements until further guidance is issued. Further, the IRS provided transition relief and guidance on the correction of certain failures by nonqualified deferred compensation plans to comply with §409A in operation.[250] The IRS also provides methods for voluntary correction of many types of failures of plan documents to comply with §409A.[251]

Section 409A does not replace other laws governing nonqualified deferred compensation. Thus, when maintained by private sector employers, the tax treatment of these plans also is governed by §402(b) (taxability of beneficiaries of a nonexempt trust), which refers to §72 (taxation of annuities) and §83 (transfers of property in connection with the performance of services). In addition, under §83, benefits are not currently taxable if the benefit is nontransferable, subject to a substantial risk of forfeiture, or a qualified employee has made an election under §83(i) to delay the taxation of certain qualified stock.[252] In

[243] *See* Rev. Proc. 2021-30, §4.05.

[244] For a detailed discussion of nonqualified deferred compensation, see 385 T.M., *Deferred Compensation Arrangements.* Nonqualified plans include supplemental executive retirement plans or "SERPs." ERISA provides for and exempts from regulation under Title I, "excess benefit plans." ERISA §3(36) defines an "excess benefit plan" to mean a plan maintained solely to provide benefits in excess of the limits on contributions and benefits imposed by §415.

[245] Such plans stand in contrast to qualified plans that are designed and intended to take advantage of the substantial tax benefits under the I.R.C. (i.e., current deductibility of employer contributions, no current inclusion in income by participants, and tax-deferred accumulation of earnings) but fail to meet the qualification requirements and thereby become disqualified.

[246] Added by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, §885.

[247] Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&As-7 and -24 through -38 (addressing information reporting and withholding requirements for deferred amounts under §409A, including reporting of nonemployee compensation). Otherwise, Notice 2005-1 is obsolete for taxable years beginning on or after January 1, 2009. *See* T.D. 9321, 72 Fed. Reg. 19,234, 19,275 (Apr. 17, 2007); Notice 2007-78; Notice 2007-86.

[248] *Modified by* Notice 2010-6. Notice 2007-89 provides similar guidance for calendar year 2007.

[249] Prop. Reg. §1.409A-4; REG-148326-05, 73 Fed. Reg. 74,380 (Dec. 8, 2008).

[250] Notice 2008-113, *modified by* Notice 2010-80, III.H., and Notice 2010-6.

[251] Notice 2010-6, *modified by* Notice 2010-80, III.A. through III.G.

[252] §83(i), added by TCJA, Pub. L. No. 115-97, §13603(a), effective for stock attributable to options exercised, or restricted stock units settled, after December 31, 2017. For initial guidance on the application of §83(i), see Notice 2018-97 (explaining the 80% availability requirement, withholding obligations, and the ability of employers to opt out of permitting employees to elect deferred

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general, the employer's deduction is postponed until amounts are included in worker's income.[253]

Nonqualified plans maintained by tax-exempt employers of governmental entities are subject to a host of additional restrictions under §457 that vastly limit their attractiveness as an executive compensation tool. If the benefit promise exceeds certain relatively modest thresholds,[254] the mere promise to pay, even if unsecured and unfunded, is subject to current tax in the absence of a substantial risk of forfeiture.

Nonqualified plans of deferred compensation are also subject to regulation as pension plans under ERISA Title I. Typically such plans avail themselves of ERISA's top-hat exception. A top-hat plan is an unfunded deferred compensation plan maintained by an employer primarily for providing deferred compensation for a select group of management or highly compensated employees. Top-hat plans are exempt from the participation, vesting, fiduciary responsibility, and funding provisions of Title I of ERISA.[255] They also are subject to more simplified reporting and disclosure rules under a regulatory exception.[256] But they are subject to the ERISA Title I enforcement provisions. There is little reliable guidance as to what constitutes the top-hat group.[257] For a thorough treatment of nonqualified deferred compensation plans, see 385 T.M., *Deferred Compensation Arrangements*, and 373 T.M., *Employee Benefits for Tax-Exempt Organizations.*

Due to both the ERISA top-hat rules and the requirements of §83, nonqualified plans usually limit participation to senior management employees. But there is nothing to prevent employers from covering independent contractors or directors. When the benefits under the plan are paid, the management employees receive taxable wages, and the directors and independent contractors have self-employment income. Unlike tax-qualified plans, for which a misclassification can lead to a host of qualification failures and also affect nondiscrimination testing, the consequences of misclassifying participants in a nonqualified plan is largely, but not entirely, confined to employment tax issues. This is in part because the eligibility provisions of nonqualified plans often either require the exercise of employer discretion (e.g., a member or senior management designated by the board) or they specify particular eligible positions (e.g., all executive vice presidents).

If a worker who is misclassified as an independent contractor can demonstrate that he or she is a common law employee of the employer then he or she will have standing to sue under ERISA's civil remedy provisions.[258] But at least two cases have held that independent contractors do not have standing to sue under ERISA:

- In *Dykes v. DePuy, Inc.*,[259] a terminated sales representative, Dykes, brought suit against his employer alleging violations of ERISA and state law nondiscrimination statutes. Dykes was covered under a compensation upon termination program sponsored by DePuy that requires participants to have 20 years of service and to meet certain sales targets. The agreement between the parties specified that the underlying employment relationship was terminable with notice. The compensation upon termination document provided that program participation did not restrict DePuy's right to terminate the employment arrangement and that, if the eligibility provisions of the program were not met prior to termination, the participant would have no right to benefits. His employment was terminated four years prior to the time he would have become eligible for benefits. The First Circuit held that Dykes was an independent contractor and that, as such, he had no rights under ERISA. It also held that there were no state law theories under which Dykes might prevail.

- *Barnhart v. New York Life Ins. Co.*[260] involved a life insurance agent, Barnhart, who sold insurance for New York Life for 16 years before being terminated for failing to meet mandatory production targets. Barnhart filed suit against New York Life under both ERISA and ADEA. The district court determined that because Barnhart was an independent contractor he lacked standing under both statutes. In upholding the lower court, the Ninth Circuit applied a multi-factor test to determine that Barnhart was an independent contractor and not a common law employee or a hybrid employee (as urged by Barnhart). In reaching its conclusions, the court gave great weight to provisions in the contract allowing either party to terminate the arrangement with or without cause.

When workers covered by nonqualified deferred compensation plans are misclassified as independent contractors, the result is violations of the employment tax and income tax withholding rules. The general rule for FICA and FUTA taxation is that amounts are treated as wages (and therefore are taxable) when the remuneration is actually or constructively paid. Section 3121(v)(2) and §3306(r)(2) furnish an exception in the form of a special timing rule for deferred compensation. Under the special timing rule, deferred amounts are taken into income

tax treatment under §83(i)). The Treasury and IRS anticipate that the guidance set forth in Notice 2018-97 will be incorporated into future regulations that, with respect to issues addressed therein, will apply to any taxable year ending on or after December 7, 2018. Any future guidance, including regulations, that address the issues in Notice 2018-97 will apply on a prospective basis only. For further discussion of §83(i), see 384 T.M., *Restricted Property — Section 83.*

[253] §404(a)(5) (governing employer deductions). Under that section, the deduction generally is postponed until the year in which the benefit is includible in the participant's income and may be taken only to the extent it is an ordinary and necessary business expense under §162 or §212. *See* Reg. §1.404(a)-12.

[254] §457(b)(2) (prescribing that the annual contribution limit to an eligible deferred compensation plan cannot be greater than the lesser of the applicable dollar amount or 100% of the participant's includible compensation). The applicable dollar amount is $15,000, as adjusted for the cost of living. §457(e)(15). For current and previous amounts, see Worksheet 1 of 371 T.M., *Employee Plans — Deductions, Contributions, and Funding.*

[255] ERISA §201(2), §301(a)(3), and §401(a)(1).

[256] 29 C.F.R. §2520.104-23.

[257] *See Demery v. Extebank Deferred Compensation Plan (B)*, 216 F.3d 283, 24 EBC 2095 (2d Cir. 2000) (a bank's deferred compensation plan maintained primarily for a select group of management or highly compensated employees, consisting of more than 15% of the bank's employees, was a top-hat plan); DOL Advisory Opinion (DOL Adv. Op.) 75-64 (plan covering highest paid 4% of employee was a top-hat plan), DOL Adv. Op. 75-48 (plan covering 23 of 14,000 employees with salaries ranging from $19,286 to $67,992 was a top-hat plan). *But cf.* DOL Adv. Op. 76-100 (plan open to all employees with three years of service was not a top-hat plan).

[258] *Firestone*, 489 U.S. at 103 (the term "employee" as defined in ERISA §3(7) includes "all employees in covered employment and former employees with a colorable claim for benefits … .").

[259] 140 F.3d 31 (1st Cir. 1998).

[260] 141 F.3d 1310, 21 EBC 2953 (9th Cir. 1998).

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when the services are performed or, if later, when there is no longer a substantial risk of forfeiture. This is also an accompanying non-duplication rule under which deferred compensation taken into account under the special timing rule together with earnings thereon will not be treated as wages when actually or constructively paid. Prior to the elimination of the ceiling on the hospital insurance portion of FICA,[261] this rule rarely caused any problems because the amounts credited to a nonqualified plan in any year normally exceeded the taxable wage base. Now that there is no cap on the hospital insurance portion, the misclassified worker will inevitably have a violation of the special timing rule. Under Reg. §31.3121(v)(2)-1(d)(1)(ii)(A), if FICA taxes are not timely paid under the special timing rule, then the amount deferred and income attributable thereto must be included as wages when actually or constructively paid.

Comment: If amounts have not been properly included in income and the employment tax return for the first year that deferred compensation should have been subject to employment tax is still open, amended employment tax returns should be filed to properly include amounts in income and take advantage of the non-duplication rule. It is not clear that any correction can be made if the first year in which amounts were no longer subject to a substantial risk of forfeiture is a closed year for the employer's employment tax return.

If a worker is classified as a common law employee and later is reclassified as an independent contractor, then the employer has unnecessarily paid some employment taxes. The employer may be able to seek a refund for employment taxes, but there should be no underpayment of tax by the employer in this instance. There is also the question of what to do about the workers' accruals under the deferred compensation plan in the event that he or she was not eligible to participate as a result of being reclassified. This situation is analytically different from the situations discussed in III.B.1., with respect to tax-qualified plans. There, the accruals were required to be distributed, forfeited or cancelled as a condition of the reinstatement of the plan's tax-qualified status. But tax qualification is not an issue here. The employer could simply amend the plan to allow for retroactive or continued participation, or both, by the reclassified worker. What is less clear is the extent to which the employer-provided accruals can be forfeited, canceled or otherwise returned to the employer.

Like their private sector counterparts, nonqualified plans of deferred compensation established by state and local governments and tax-exempt organizations under §457 are permitted to cover independent contractors.[262] But there are some important constraints. Participation in the plan is required to be nonelective, and there can be no individual variations or options under the plan. Deferred compensation of independent contractors is considered nonelective only if all individuals with the same relationship to the payor are covered under the same plan, with no individual variations or options.[263] The IRS provides guidance describing the withholding and reporting requirements that apply to §457(b) plans. The guidance addresses withholding and reporting with respect to annual deferrals to, and distributions from, §457(b) plans, FICA payment and reporting, the use of employer identification numbers in connection with trusts established under §457(g), and annual reporting requirements.[264]

E. Welfare and Fringe Benefit Plans

Welfare benefits are described in ERISA §3(1). They include group health plans; life, travel, accident, accidental death and dismemberment (AD&D) programs, and long-term disability plans; vacation, scholarship, apprenticeship, and other training programs; funded short-term disability plans (unless statutory); severance plans; long-term care plans; housing assistance; day care centers; and pre-paid legal services.[265] Unlike ERISA-covered pension plans, ERISA-covered welfare plans are exempt from ERISA's participation, funding and vesting requirements.[266]

As a result of comprehensive federal health care reform,[267] certain employers must either offer group health plan coverage to full-time employees or pay an assessment. These rules, which are imposed only on applicable large employers — i.e., employers with 50 or more full time and "full-time equivalent" employees — are codified in §4980H.[268] For this purpose, only

[261] Former §3121(x), struck by Pub. L. No. 103-66, §13207(a)(1)(B).

[262] §457(e)(12); Reg. §1.457-2(j).

[263] §457(e)(12)(B).

[264] *See* Notice 2003-20, updating and superseding Notice 2000-38, for contributions and distributions made after December 31, 2001. However, Notice 2003-20, §IX, provides that for deferrals or distributions made after December 31, 2001, and before January 1, 2004, the IRS will not assert that there has been a failure to comply with applicable reporting and withholding requirements if the requirements set forth in Notice 2000-38 have been satisfied. Note that neither notice addresses deferrals made on behalf of independent contractors.

[265] ERISA §3(1); 29 C.F.R. §2510.3-1. Excluded from coverage under ERISA are governmental plans, church plans, and plans maintained for workers' compensation, unemployment compensation or disability insurance laws (ERISA §4(b)(3)), and plans maintained outside the U.S. primarily for nonresident aliens (ERISA §4(b)(4)). 29 C.F.R. §2510.3-1 excludes from coverage under ERISA certain payroll practices including overtime pay, shift premiums, and holiday or weekend premiums; payment of normal compensation from an employer's general assets where the employee is unable to perform his or her duties (i.e., disability) or is on a leave of absence; recreational or dining facilitates; holiday gift items; strike funds maintained by an employee organization; and group or group-type insurance programs offered to employees by an insurer under which no employer contributions are made, participation is voluntary, and the employer does not actively sponsor the plan (e.g., tax-sheltered annuity plan). 29 C.F.R. §2510.3-1(b) and §2510.3-1(k) exclude from coverage under ERISA unfunded sick pay, vacation and educational assistance plans. Also excluded are unfunded or fully insured plans for top executives under 29 C.F.R. §2520.104-24; plans covering only individuals who are not employees, such as partners or outside directors under 29 C.F.R. §2510.3-3(b) and §2510.3-3(c) (but see the discussion in IV.C.4., below); liability or casualty insurance plans (DOL Adv. Op. 91-33A); and referral-only employee assistance plans (DOL Adv. Op. 83-35A and DOL Adv. Op. 91-26A). For discussion of guidance regarding whether a "group or association" of employers may elect to act as a single "employer" under ERISA §3(5) to establish an "association health plan" that is an employee welfare benefit plan and a group health plan under ERISA, see 395 T.M., *VEBAs and Other Welfare Benefit Funding Arrangements.*

[266] ERISA §201(1), §301(a)(1) (describing the scope of the ERISA coverage and funding rules).

[267] The Patient Protection and Affordable Care Act, Pub. L. No. 111-148, as amended by the Health and Education Reconciliation Act of 2010, Pub. L. No. 111-152 (collectively, the "ACA"). For a detailed discussion of the ACA, see 335 T.M., *Health Care Reforms — Implications for Employee Benefit Plans.*

[268] As added by Pub. L. No. 111-148, §1513(a), and amended by Pub. L. No. 111-152, §1003, effective for months beginning after December 31, 2013; Notice 2013-45 (transition relief through 2014 for all employers); T.D. 9655, 79 Fed. Reg. at 8543–8601 (preamble §XV.D) for 2015 transition relief for employers with fewer than 100 full time or full-time equivalent employees and special 2015 rules for other employers). For guidance on counting employees for purposes of determining whether an employer is an applicable large employer, see Reg. §54.4980H-2, T.D. 9655, 79 Fed. Reg. at 8543–8601.

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common law employees are counted. The definition does not include leased employees, real estate agents or direct sellers.[269] There is a very limited exemption under which seasonal employees are not counted for this purpose.[270] Penalties under §4980H are determined with reference to full-time employees. A full-time employee for this purpose is an employee who works 30 or more hours per week.[271] These rules are discussed in more detail in VI. and 332 T.M., *Employer Shared Responsibility*.

Importantly, the rules do not require any employer to make group health plan coverage available; rather, employers that fail to do so under the terms prescribed by §4980H may be subject to an assessment in the nature of a nondeductible excise tax. The rules apply differently under the following two-pronged tests depending on whether an employer offers coverage to *all*[272] full-time employees:

- No coverage prong: Where an applicable large employer fails to offer coverage to all its full-time employees,[273] and where at least one full-time employee qualifies for low-income health insurance subsidies through the insurance exchanges, §4980H(a) imposes an annualized penalty of $2,000 (as adjusted for inflation), which is determined and assessed monthly, multiplied by the number of the employer's full-time employees in excess of 30, including those who do not qualify for any low-income subsidies to purchase health insurance though an insurance exchange.[274] An individual is subsidy-eligible if his or her household income is not more than 400% of the federal poverty limit.

- Coverage prong: Where an applicable large employer offers coverage to all its full-time employees, §4980H(b) imposes an annualized penalty of $3,000 (as adjusted for inflation), which is determined and assessed monthly, multiplied by the number of the employer's full-time employees who are certified to the employer as having received an applicable premium tax credit or cost-sharing reduction with respect to the employee's purchase of health insurance for the employee on one of the insurance exchanges. But the penalty under this coverage prong cannot exceed the penalty that the employer would have paid had it offered no coverage.[275] Where the value of the plan coverage dips below a certain level, employees need only establish that their household income is not more than 400% of the federal poverty limit in order to qualify for the subsidy.[276] But where the value of the plan coverage exceeds that threshold, employees must also establish that their premium cost for the employer's plan exceeds 9.5% (as adjusted) of their household income.[277]

When applying the rules under §4980H, employee classification is critically important, for purposes of determining (1) whether an employee has 50 or more full-time equivalent employees and is, therefore, subject to the rule, and (2) the amount of the penalty, if any, which is calculated with reference to the number of the employer's full-time employees. In the first instance, determining whether an employer is an applicable large employer that is subject to the ACA's employer responsibility requirements depends on properly identifying and counting full-time equivalent employees. An improperly excluded worker or workers may result in an employer incorrectly assuming the rules are not applicable. Depending on the facts and circumstances, the difference between the penalties under the coverage and no-coverage prongs of §4980H can be substantial. For example, an employer with 1,030 employees that fails to offer coverage to all its full-time employees would be subject to an annual assessment under §4980H(a) of $1,000,000 ($2,000 × (1,030 − 30)). In contrast, if the same employer offers coverage to all full-time employees, and if 20 of its full-time employees are subsidy eligible, the annual assessment would be the lesser of $60,000 ($3,000 × 20) or $1,000,000 (the penalty under the no-coverage prong), or $60,000.

Fringe benefits are a form of non-cash compensation for the performance of services that would ordinarily constitute taxable income under §61 to the extent of their fair market value. Congress singled out certain fringe benefits for favorable tax treatment, however, when provided pursuant to a fringe benefit plan that satisfies the requirements set out in the I.R.C. These requirements usually involve some sort of nondiscrimination test or standard that prevents benefits from being weighted in favor of a prohibited group of employees.[278] Fringe benefit plans that provide welfare-type benefits described in

[269] Reg. §54.4980H-1(a)(15); T.D. 9655, 79 Fed. Reg. at 8567–8568 (preamble §XII).

[270] §4980H(c)(2)(B). *See* Reg. §54.4980H-2(b)(2); T.D. 9655, 79 Fed. Reg. at 8543 (preamble §IX.B).

[271] §4980H(c)(4). *See* Reg. §54.4980H-3.

[272] Reg. §54.4980H-4(a) provides that an employer that provides coverage to all but five percent (or, if greater, five) of its full time employees is considered to be offering coverage to all employees.

[273] In addition to the ability to exclude a de minimis number of employees without incurring the penalty, if a PEO or other staffing firm that is not a common law employer of a worker makes an offer of coverage to an employee who is performing services for a client of the PEO or other staffing firm, it is treated for §4980H purposes as an offer of coverage made by the client as long as certain conditions are satisfied. Reg. §54.4980H-2(b)(2); T.D. 9655, 79 Fed. Reg. at 8566 (preamble §IX.B).

[274] Established under Pub. L. No. 111-148, §1311(b). *See* Reg. §54.4980H-4. See VI.B. for a more detailed discussion.

[275] §4980H(b)(2). Section 4980H(c)(5) adjusts the penalty amounts for inflation after 2014. For the inflation-adjusted amounts, see the discussion of §4980H liability in and the Worksheets of 332 T.M., *Employer Shared Responsibility*.

[276] The 400% of the federal poverty level limit on household income does not apply for taxable year beginning in 2021 through 2025. §36B(c)(1)(E), added by the American Rescue Plan Act of 2021, Pub. L. No. 117-2, §9661(b), effective for taxable years beginning after December 31, 2020, and amended by the Inflation Reduction Act, Pub. L. No. 117-169, §12001(b), effective for taxable years beginning after December 31, 2022. Thus, employers should ensure that the plan provides minimum value.

[277] §36B(c)(1)(A) and §36B(c)(2)(C), added by Pub. L. No. 111-148, §1401(a). *See* Reg. §1.36B-2(b)(1) and §1.36B-2(c)(3)(v); Prop. Reg. §1.36B-2(c)(3)(v)(A)(7), REG-109086-15, 81 Fed. Reg. 44,557 (July 8, 2016) (effect of opt-out arrangement on affordability determination). *See also* Reg. §54.4980H-5 (safe harbors for determining whether employer's plan is affordable under coverage prong); T.D. 9655, 79 Fed. Reg. at 8545 (preamble §II.B).

[278] The separate categories of prohibited groups of employees include: (1) highly compensated individuals under §105(h); (2) highly compensated participants and individuals under §125(e); (3) highly compensated employees under §414(q); and (4) key employees under §416(i). In most cases, the applicable nondiscrimination tests are applied taking into account not only the employees of the employer that sponsors the plan but also all of the other entities within the same control group within the meaning of §414(b) and §414(c) and within the same affiliated service group within the meaning of §414(m). Section 414(t) catalogs the list of affected fringe benefit plans. They include §79, §106, §117(d), §125, §127, §129, §132, §137, §274(j), §505, and §4980B.

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ERISA §3(1) also are regulated as welfare plans.[279] Where a plan is both an ERISA-covered welfare plan and a fringe benefit plan under the I.R.C., the statutory scheme operates in a manner similar to that described above with respect to tax-qualified retirement plans: the participant protections are furnished under ERISA and the tax consequences are prescribed by the I.R.C. Where the fringe benefit plan is not also an ERISA plan, the I.R.C. continues to govern the tax treatment of the benefit, but state and local law provides the remedies available to participants and beneficiaries.

Fringe benefits are taxable unless excluded from income under a particular I.R.C. provision. Where the recipient of a taxable fringe benefit is an employee, the benefit is subject to employment taxes and must be reported as income on the employee's Form W-2. Special rules apply to the withholding, deposit and reporting of employment taxes.[280]

Where workers covered under welfare or fringe benefit plans are misclassified, the following tax, benefits and reporting consequences can occur:

• *Tax Consequences.* The tax consequences of worker misclassification where fringe benefit plans are concerned are generally less onerous than in the case of tax-qualified retirement plans. Including a worker who is a non-common law employee will typically result in the tax benefits being unavailable to the worker. The balance of the fringe benefit plan is generally unaffected,[281] and the common law employees covered under the plan will continue to enjoy the tax benefits. Although the item of income will not be subject to employment taxes or income tax withholding, the employer will need to file the appropriate information return,[282] and the worker will be liable for self-employment taxes. Where common law employees are improperly excluded, the applicable nondiscrimination tests will be affected. When the reclassification of the employee results in a testing failure, the most common remedy is to deny the tax advantages of the particular benefit to highly paid employees. The tax benefits of rank-and-file employees are usually, but not always, left undisturbed.[283] In at least one instance, relating to qualified achievement awards, the employer's deduction is denied where the benefit is determined to discriminate in favor of prohibited group employees.[284]

• *Benefits Consequences.* Unlike tax-qualified pension, profit sharing and stock bonus plans, with respect to which the inclusion of non-employee independent contractors can result in plan disqualification (*see* III.B.), welfare and fringe benefit plans are free to include independent contractors as participants.[285] These latter plans do not face the risk of plan disqualification. But the tax treatment of independent contractors who participate in a welfare benefit or fringe benefit will in most cases be less favorable. For example, while an employee covered under an employer's group health plan may escape tax on benefits or employer and employee premiums under §105(b), §106, and §125, respectively, an independent contractor covered under the same plan is taxed either on contributions or benefits as amounts are not excluded under §106 or §105(a), respectively. Of course, to the extent that the contractor is taxed on benefits paid to him or her or reimbursed on his or her behalf, the contractor will be able to claim an above the line deduction.[286]

More common and problematic are instances in which a welfare or fringe benefit plan that by its terms covers only *employees* erroneously or improperly covers a worker who is not an employee. Or a plan might erroneously or improperly exclude a worker who is in an eligible class of employees. A non-employee worker who is mistakenly covered by a fringe benefit or welfare plan will not under ordinary circumstances gain any enforceable rights.[287] But the mistakenly excluded worker will.[288] The particular rights to which the mistakenly excluded employee is entitled will depend on whether the welfare or fringe benefit plan is governed by ERISA or state law. Welfare plans, irrespective of whether they are also fringe benefit plans, are governed by ERISA unless exempt from coverage under ERISA §4(b) (i.e., governmental plans, non-electing church plans, plans maintained solely to comply with workmen's compensation, unemployment compensation or disability insurance

[279] These include group-term life insurance plans, accident and health plans, medical flexible spending accounts, long-term disability plans, and certain short-term disability and severance pay arrangements, among others, maintained by private sector employers other than churches.

[280] *See* IRS Publication 15, Circular E, Employer's Tax Guide. *See also* Announcement 85-113.

[281] *Cf.* §125(d)(1)(A) (defining a cafeteria plan as "a written plan under which … all participants are employees") *and* §127 (requiring that an educational assistance plan be maintained as a separate written plan for the exclusive benefit of employees). With the inclusion of workers who are not common law employees, the tax benefits are lost to all participants.

[282] Form 1099-NEC (tax years after 2019) or Form 1099-MISC (tax years before 2020) with respect to an independent contractor; Schedule K-1 (Form 1065) with respect to a partner; and Schedule K-1 (Form 1120S) with respect to an S corporation shareholder.

[283] *E.g.*, §127(a)(1) and §127(b) (where educational assistance program discriminates in favor of highly compensated employees, all participants will be required to include benefits in income).

[284] §74(c) and §274(j), as amended by TCJA, Pub. L. No. 115-97, §13310, applicable to amounts paid or incurred after December 31, 2017; Prop. Reg. §1.274-8(a).

[285] *See, e.g.*, *Turnoy v. Liberty Life Assurance Co. of Boston*, 2003 U.S. Dist. LEXIS 1311, 29 EBC 2609 (N.D. Ill. Jan. 30, 2003) (holding that an independent contractor may be entitled to receive benefits under a welfare benefits plan); *accord Yates v. Fleetwood Transp. Servs.*, 2007 U.S. Dist. LEXIS 79497, 42 EBC 1810 (W.D. La. Oct. 26, 2007); *Shyman v. UNUM Life Ins. Co. of Am.*, 2004 U.S. Dist. LEXIS 4964 (N.D. Ill. Mar. 25, 2004), *aff'd*, 427 F.3d 452, 454, 36 EBC 1016 (7th Cir. 2005); *Ruttenberg v. U.S. Life Ins. Co.*, 413 F.3d 652 (7th Cir. 2005), *Ziesemer v. First Unum Life Ins. Co.*, No. 04-6429, 2006 BL 90683 (D.N.J.Aug. 18, 2006).

[286] §162(l). The amount deducted under §162(l) may not also be deducted under §213(a). §162(l)(3). The amount that may be deducted under §162(l) is not limited to amounts in excess of the adjusted gross income threshold set by §213, which is discussed in III.E.2., below.

[287] *See Walsh v. Gillette Co.*, 2005 BL 33479, 36 EBC 2154 (D. Mass. 2005) (dismissing a claim by a worker classified as an independent contractor who alleged that he was a common-law employee and as such was entitled to life, health, and disability insurance benefits, vacation pay, performance bonuses, and other benefits). According to the court, "[c]ommon law employees do not have any right to benefits that are extended to other employees." *Id.*

[288] The courts have been generally reluctant to provide these remedies where welfare benefits are concerned. *But cf. Varity Corp. v. Howe*, 516 U.S. 489, 19 EBC 2761 (1996) (awarding welfare plan beneficiaries injunctive relief based upon claim that their employer breached its ERISA fiduciary duties by intentionally misrepresenting to employees that their welfare benefits would remain secure following transfer to newly established subsidiary).

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laws, plans maintained outside the United States primarily for nonresident aliens, and unfunded excess benefit plans). State and local laws govern misclassified workers' rights under fringe benefit plans that are not covered under ERISA:

• *Reporting Consequences.* Misclassifying workers can result in reporting errors as well. ERISA-covered welfare benefit plans are subject to the reporting requirements imposed by ERISA §102. Fringe benefit plans are subject to a separate set of reporting requirements under §6039D. Where a fringe benefit plan is also a welfare plan, both sets of reporting rules apply, although it is also possible to comply with both sets of reporting obligations in the same annual reporting form (Form 5500 in most cases). 29 C.F.R. §2520.104-20 exempts from the reporting requirements of ERISA §104(a) certain welfare plans with fewer than 100 participants. Section 6039D contains no such exemption, but filing requirements under §6039D are suspended for §125 cafeteria plans and other fringe benefit plans.[289]

Comment: While the Microsoft inoculation language discussed in III.B.4. first surfaced in connection with §401(k) plans, the policy concerns that underlie the development of these provisions are similar if not identical in the case of welfare and fringe benefit plans. Plan sponsors should therefore be able to include such provisions in their plans so as to cut off claims that the reclassified worker is entitled to retroactive plan participation under ERISA or state law, as the case may be. But the only current guidance on the efficacy of these provisions is the July 28, 1999 Technical Advice Memorandum (unreleased), discussed in III.B.4., which cannot be relied on as precedent. Moreover, even if that TAM did have precedential value, its narrow holding was simply that "inoculation" provisions would not prevent the issuance of a favorable determination letter in the case of a tax-qualified plan. The Department of Labor, which has jurisdiction over the protection of participant rights under Title I of ERISA, has not yet taken a position with respect to these types of provisions.

To facilitate the analysis of the various consequences of worker misclassification where fringe benefit plans are concerned, it helps to group the fringe benefit provisions of the I.R.C. into the following three categories:

• In the event that the suspension of I.R.C.-based reporting requirements is lifted,[290] §6039D covers the following fringe benefit plans: (i) group-term life insurance purchased for employees (§79); (ii) amounts received under accident and health plans (§105); (iii) contributions by employers to accident and health plans (§106); (iv) amounts received under qualified group legal services plans (former §120);[291] (v) cafeteria plans (§125); (vi) educational assistance programs (§127); (vii) dependent care assistance programs (§129); and (viii) adoption assistance programs (§137). In addition to a separate I.R.C.-based reporting requirement, and with the exception of adoption assistance programs not offered under a §125 cafeteria plan, the fringe benefit plans identified in §6039D each include one or more nondiscrimination requirements that make them vulnerable to failure and thus income inclusion at least for the highly compensated employees where the improper exclusion of workers results in the violation of an applicable nondiscrimination standard or rule. These plans are discussed in III.E.1.–III.E.7.

• While not subject to a separate set of reporting requirements, the following fringe benefits each require that they cover either all employees or a nondiscriminatory class of employees: qualified achievement awards (§74 and §274(j)); employer-operated eating facilities for employees (§132(e)(2)); qualified employee discounts (§132(a)(2)); no-additional cost services (§132(a)(1)); qualified tuition reduction (§117(d)); qualified retirement planning services (§132(m)); and athletic facilities (§132(j)(4)). These plans are discussed in III.E.8.

• This group of fringe benefit plans is of little concern where misclassified workers are concerned. In the absence of any nondiscrimination rules, the only issues are tax-related (i.e., the worker will not be able to exclude the benefit from income). In this category are (nonqualified) achievement awards (§74 and §274(j)); meals and lodging furnished for the convenience of the employer (§119); qualified moving expense reimbursements (§132(a)(6) and §217); qualified transportation fringe benefits (§132(f)); and working condition fringe benefits (§132(d)). These plans are discussed in III.E.9.

1. *Group-Term Life Insurance Purchased for Employees (§79)*

Section 79 allows employers to provide employees with group-term life insurance coverage on a tax-advantaged basis. Under a properly structured group-term life plan, an employer can provide each employee up to $50,000 of group-term life insurance coverage without the employee having to recognize income on the cost of the insurance. Employees include (1) current common law employees, (2) full-time life insurance salespersons who are statutory employees, (3) individuals who were formerly employees under (1) or (2) above, and (4) leased employees under §414(n).[292] Partners and 2% shareholders of S corporations are not employees for this purpose.[293] The employer is provided with a deduction for the cost of providing coverage. Coverage in excess of $50,000 of death benefit is included in the employee's taxable income.

[289] In Notice 90-24, the IRS suspended the annual return requirement (filing Schedule F of Form 5500) for employers maintaining fringe benefit plans under §79, §105 and §106, and §129. In Notice 2002-24, which modifies and supersedes Notice 90-24, the IRS suspended the Schedule F filing requirement for employers maintaining fringe benefit plans under §125, §127 or §137, effective April 22, 2002, and applicable to all plan years for which information returns have not been filed. The notice does not affect annual reporting requirements under Title I of ERISA. Following Notice 2002-24, lines 8c and 10c of Schedule F of Form 5500 and the filing instructions for fringe benefit plans were removed. *See* 2002 Instructions for Form 5500.

[290] Notice 2002-24.

[291] This exclusion expired for taxable years beginning after June 30, 1992. Former §120(e). Pub. L. No. 113-295, Div. A, §221(a)(19), removed former §120 from the I.R.C., effective December 19, 2014.

[292] Reg. §1.79-0. *See* §414(n)(3)(C).

[293] Section 1372 treats a more than 2% shareholder of an S corporation as a partner for employee fringe benefit purposes.

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Life insurance provided to employees under a group-term life insurance plan cannot qualify for favorable tax treatment under §79 unless it covers at least 10 full-time employees, or all of the employer's full-time employees if the employer employs less than 10 full-time employees.[294] There is a second exception to the 10-employee rule that affects plans maintained by unrelated employers.[295] In applying either exception, the following employees are excluded: (1) employees who are 65 or older, (2) employees who customarily work no more than 20 hours a week or five months in a calendar year, and (3) employees who have not satisfied a waiting period that does not exceed six months.[296]

Section 79(d) bars key employees from receiving the exclusion from income under §79(a) unless the plan under which the coverage is provided does not discriminate in favor of key employees with regard to eligibility and the type and amount of benefits available to participants. Section 79(d)(6) defines key employee essentially the same way as that term is defined in §416(i)(1), except that the term also includes any former employee who was a key employee when he retired or separated from service.[297]

Under §79(d)(3)(A), a group-term life insurance plan is treated as nondiscriminatory as to eligibility if it covers one of the following classifications of employees: (1) 70% or more of all employees of the employer, (2) at least 85% of all employees who are participants under the plan and are not key employees, (3) such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of key employees,[298] or (4) in the case of a plan that is part of a cafeteria plan, the requirements of §125 are met. Section 79(d)(3)(B) allows certain employees to be excluded from consideration. They include (i) employees who have not completed three years of service,[299] (ii) part-time or seasonal employees, (iii) employees not included in the plan who are included in a unit of employees covered by a collective bargaining agreement between employee representatives and the employer, provided that group-term life insurance benefits were the subject of good faith bargaining,[300] and (iv) nonresident aliens who receive no U.S. source earned income from the employer. According to the Conference Report,[301] part-time employees are those employees whose customary employment is for no more than 20 hours in any one week and seasonal employees whose customary employment is for no more than five months in any calendar year. A plan is deemed to be nondiscriminatory as to benefits if it makes the same benefits available to key employee participants as are made available to all other participants.[302] But a plan is not considered discriminatory merely because the amount of life insurance provided to participants bears a uniform relationship to the participants' total compensation or their basic regular rate of compensation.[303]

If a group-term life insurance plan is discriminatory, the exclusion provided by §79 will be unavailable to key employees and the cost of group term life insurance coverage will be the greater of the amount determined in the regulations or the actual cost.[304] A plan that improperly includes independent contractors or excludes workers who are common law employees risks violating the nondiscriminatory eligibility requirement of §79(d)(2)(A), in which case the entire cost of the insurance must be included in the wages of key employees and be subject to FICA taxes.

Comment: Improper exclusion can also affect the application of the 10-employee rule and its exceptions. Assume an employer with six employees also retained the services of an individual over a period of years on a substantially full-time basis and at all relevant times treated this individual as an independent contractor. In the course of an employment tax audit, it is determined that the independent contractor is a common law employee. The result is a violation of the 10-employee rule because not all of the employer's full-time employees are covered. An arrangement that violates the 10-employee rule does not qualify as "group-term life insurance" within the meaning of §79. Therefore, the §79 exclusion is lost for all employees of the employer for the open tax years and not just the key employees and the employer will be liable for income and employment tax withholding.

For a detailed discussion of the requirements of group-term life arrangements, see 386 T.M., *Insurance-Related Compensation.*

2. *Amounts Received Under Accident and Health Plans (§105) and Contributions by Employer to Accident and Health Plans (§106)*

The taxation of medical benefits is governed by three interrelated sections of the I.R.C. Section 104 provides exclusions from an individual's gross income for amounts received from workers' compensation, as damages for personal injuries, and from accident and health benefit coverage not financed by an employer. Thus, an individual can receive benefits under a disability or medical insurance plan tax-free, but only if he or she has paid the premiums with after-tax dollars.[305] Without the exclusions provided by §105(b), benefit payments would be included in taxable income under §61. A corresponding deduction would be available either under §213(a) (with respect to

[294] Reg. §1.79-1(c)(1) and §1.79-1(c)(2).

[295] Reg. §1.79-1(c)(3).

[296] Reg. §1.79-1(c)(4).

[297] EGTRRA, Pub. L. No. 107-16, §613 amended the definition of "key employee" for plan years commencing after December 31, 2001 to mean (i) an officer with compensation in excess of $130,000 (adjusted for inflation in $5,000 increments), (ii) a 5% owner, or (iii) a 1% owner with compensation in excess of $150,000. The prior law definition of "key employee" that included 10 employees earning more than the defined contribution plan limits ($35,000 in 2001) and owning the largest interests in the employer was dropped altogether. For the current and prior year dollar amount used in identifying a key employee, see Worksheet 1 of 371 T.M., *Employee Plans — Deductions, Contributions, and Funding.*

[298] While there is no guidance as to how to apply this "reasonable classification" test set out in §79(d)(3)(A)(iii), it is reasonable to look to the rules of §410(b)(2)(A)(i) and Reg. §1.410(b)-4(b).

[299] There is no guidance as to what constitutes a "year of service" for purposes of §79. *Cf.* §129(d)(9)(A) (relating to dependent care assistance plans, cross-references §410(a)(3) and §410(b)(4), which prescribe the 1,000-hour-of-service measure that applies to qualified plans).

[300] This provision is similar to that found in §410(b)(3)(A). Section 7701(a)(46) excludes from the definition of "employee representatives" any organization "more than one-half of the members of which are employees who are owners, officers, or executives of the employer." *See* Reg. §301.7701-17T.

[301] H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 634 (1982).

[302] §79(d)(4).

[303] §79(d)(5).

[304] §79(d)(1); Reg. §1.79-4T, Q&A-6.

[305] §104(a)(3).

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medical expenses) but only to the extent that it exceeds 7.5% of adjusted gross income.[306]

Under §105(a), amounts received by an employee through accident or health insurance for personal injuries or sickness are *taxable* to the extent such amounts are either attributable to employer contributions that were not includible in the gross income of the employee or were paid by the employer. Section 105(b) and §105(c) contain the exceptions to the general rule of §105(a) with which employers and employees are familiar, and on which they have come to rely. The exceptions are for (1) amounts expended for medical care (i.e., medical expense reimbursements) under §105(b), and (2) permanent injury payments within the meaning of §105(c). Under §105(b), amounts expended for medical care are those allowed under §213[307] for the employee and his or her spouse and "dependents" within the meaning of §152(a). Similarly, §105(c)(1) allows for payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement of the employee, his or her spouse, or a dependent, so long as such payments are computed with reference to the nature of the injury and without regard to the period the employee is absent from work.

The ACA greatly expanded group health plan coverage of adult children (i.e., a child of an employee who has not attained age 26) by enacting a substantive coverage provision applicable to group health plans and extending favorable tax treatment for plan participants under §105(b). Beginning with plan years beginning after September 23, 2010, group health plans that cover dependent children generally must include and cover adult children until they attain age 26 (i.e., through age 25), irrespective of the adult child's marital status.[308] A plan may not condition child coverage on any factors other than the parent-child relationship between the child and a plan participant, and the requirement that the child be under the age of 26. Thus, a plan cannot (1) charge different premiums or cost sharing on, or make different coverage options available to, different age groups of age 26-and-under children; (2) require that the age 26-and-under children show residency, financial dependency, student status, or unemployment status in order to obtain coverage; (3) deny an age 26-and-under child coverage because he is eligible for other employer's coverage (although grandfathered plans had the right to do this for plan years beginning before January 1, 2014);[309] or (4) deny an age 26-and-under child coverage because he is married (however, spouses of the covered child, or children of the covered child, need not be covered). As of March 30, 2010, the ACA amended §105(b) to extend favorable tax treatment to an adult child who has not reached age 27 as of the end of the taxable year, including a child who is not the employee's dependent within the meaning of §152(a). The term child for purposes of this rule means an individual who is a son, daughter, stepson, stepdaughter or eligible foster child of the taxpayer.[310] Thus, for example, a 25-year-old child who does not live at home must be allowed to be covered on his or her parent's policy without the parent having to include in income the fair market value of the coverage.

It is not an accident or mistake that the ACA's substantive coverage provisions, under which group health plans that cover dependent children must generally cover adult children until they attain *age 26*, and the expansion of favorable tax treatment under the ACA's amendments to §105(b), which extend favorable tax treatment to an adult child who has not reached *age 27*. It is, rather, purposeful. This way, plans that make changes only during an annual open enrollment can provide favorable coverage to an adult child who attains age 26 mid-year through the end of the plan or policy year.

For purposes of §105(b), amounts paid (directly or indirectly) to a qualified taxpayer from certain governmental health plans do not fail to be excluded from gross income solely because the plan provides for reimbursements of health care expenses of a deceased employee's beneficiary (other than the spouse, dependent or child). For this purpose, a qualified taxpayer is the employee or the spouse, dependent or child of the employee. Beginning on March 30, 2010, children include chil-

[306] §213(a), as amended by the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Div. EE of the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, §101(a), effective for taxable years beginning after December 31, 2020. Previously, although the medical expense deduction "floor" under §213(a) was raised to 10% from 7.5% for taxable years beginning after December 31, 2012, §213(f) temporarily reduced the percentage to 7.5% for all individuals for taxable years beginning in 2017, 2018, 2019 and 2020. §213(a), as amended by the ACA, Pub. L. No. 111-148, §9013(a), §213(f), added by Pub. L. No. 111-148, §9013(b) (retaining 7.5% threshold if taxpayer or spouse attained age 65 before the close of the taxable year for taxable years ending before January 1, 2017), amended by TCJA, Pub. L. No. 115-97, §11027(a) (applying 7.5% to all taxpayers for taxable years ending before January 1, 2019), effective for taxable years beginning after December 31, 2016, and by Pub. L. No. 116-94, Div. Q, §103(a) (extending 7.5% for taxable years beginning before January 1, 2021), effective for taxable years ending after December 31, 2018, and struck by the Taxpayer Certainty and Disaster Tax Relief Act of 2020, §101(b). The 7.5% floor also applied temporarily for the alternative minimum tax computation for taxable years beginning in 2017, 2018, 2019, and 2020. *See* former §56(b)(1)(B), as amended by TCJA, Pub. L. No. 115-97, §11027(b), effective for taxable years beginning after December 31, 2016, before removal by Pub. L. No. 116-94, Div. Q, §103(b). For taxable years beginning in 2013, 2014, 2015, and 2016, the 10% floor applied for the AMT computation, even for seniors. §56(b)(1)(B), as amended by Pub. L. No. 111-148, §9013(c).

[307] §213(d). The term "medical care" means amounts paid — (A) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, (B) for transportation primarily for and essential to medical care referred to in subparagraph (A), (C) for qualified long-term care services (as defined in §7702B(c)), or (D) for insurance (including amounts paid as premiums under part B of title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged) covering medical care referred to in subparagraphs (A) and (B) or for any qualified long-term care insurance contract (as defined in §7702B(b)). In the case of a qualified long-term care insurance contract (as defined in §7702B(b)), only eligible long-term care premiums (as defined in paragraph (10)) shall be taken into account under subparagraph (D). §213(d) Also, medical care includes dental care. Reg. §1.213-1(e)(1)(ii). Note, however, that amounts are not excludible from gross income under §105(b) if the plan permits amounts to be paid as §213(d) medical benefits to a designated beneficiary other than the employee's spouse or dependents. Rev. Rul. 2006-36, *modified by* Notice 2007-22, *amplified by* Notice 2008-59, with respect to qualified health savings account distributions under §106(e). If a reimbursement plan contains a provision on or before August 14, 2006, stating that upon the death of a deceased employee's surviving spouse and last dependent, or upon the death of the employee, if there are no surviving spouse or dependents, any unused reimbursement amount will be paid as a reimbursement of substantiated medical care expenses of a beneficiary designated by the employee, Rev. Rul. 2006-36 is effective with respect to that provision for plan years beginning after December 31, 2008.

[308] Public Health Service Act §2714, added by Pub. L. No. 111-148, §1001(5), and amended by Pub. L. No. 111-152, §2301(b); Notice 2010-38.

[309] *See* Pub. L. No. 111-148, §1251(a)(4)(B)(ii), as amended by Pub. L. No. 111-148, §10103(d), and Pub. L. No. 111-152, §2301(a).

[310] Pub. L. No. 111-152, §1004(d) (amending §105(b), §162(l), and §501(c)(9)).

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dren who have not attained the age of 27. The plan must have provided for reimbursement of a deceased participant's beneficiary on or before January 1, 2008, and must be an accident or health plan funded by a medical trust that is established in connection with a public retirement system or by or on behalf of a state or political subdivision, if such trust (1) has been authorized by a state legislature, or (2) has received a favorable ruling from the IRS that the trust's income is not includible in gross income under §115 (exclusion from gross income for states and their political subdivisions) or §501(c)(9) (the exemption for VEBAs).[311]

Section 105 governs the tax treatment of amounts received by an employee, i.e., the actual benefits paid or reimbursed to an employee under an accident and health plan. Section 106 provides that employer-paid coverage under an accident or health plan is not taxable to the employee. Thus, under a typical insured medical plan, §106 ensures that premiums paid by the employer on an employee's behalf are not included in the employee's income, and §105(b) exempts from the employee's income any medical benefits paid on his behalf under the plans. These exclusions from income extend to employment taxes and income tax withholding.[312]

Employees also can exclude from income amounts paid to them to reimburse them for accident or health insurance premiums so long as they provide the employer with proof of payment.[313] The employee contribution toward medical plan premiums or costs would, in the absence of §125, be taxable under §451[314] because the individual would have the ability to get cash compensation without any substantial limitation.[315] Contributions under §125 cafeteria plans are discussed in III.E.3.

These three statutory provisions, read together, govern the tax consequences of medical and disability benefits. Section 104 is not limited to employees. Any individual that purchases coverage with after-tax dollars will be able to exclude payments received as a result. For purposes of §105 and §106, the term employee means and includes (1) a common law employee, (2) a full-time life insurance agent who is a current statutory employee, (3) a retired employee, (4) a widow or widower of an individual who died while an employee, (5) a widow or widower of a retired employee, and (6) a leased employee under §414(n).[316] Self-employed individuals, partners and 2% shareholders of S corporations are not employees for this purpose. These individuals generally are treated the same as employees under §104(a)(3). Therefore, a self-employed individual who pays premiums for medical or disability insurance will be able to exclude benefit payments from income. Self-employed workers can deduct medical expenses in excess of the statutory threshold percentage of gross income,[317] because under §162(l)(1) they can deduct up to 100% of the costs of providing accident and health insurance coverage.[318] For purposes of §105, self-employed persons are not treated as employees.[319]

Premium payments under a fully insured medical plan or contributions to a self-funded arrangement constitute taxable income to any worker covered under the plan (other than as a spouse or dependent) if that worker is not a common law employee. The further consequences of worker misclassification, particularly where common law employees are excluded from coverage, depend on whether the plan is insured or self-insured.

[311] §105(j), enacted by Pub. L. No. 110-458, §124, effective with respect to payments made before, on or after December 23, 2008, and amended by Pub. L. No. 114-113, Div. Q, §305 (defining qualified taxpayer, extending special rule to benefits paid by state-established plans and VEBA trusts), effective for payments after December 18, 2015.

[312] §3121(a)(2) and §3306(b)(2); Reg. §31.3401(a)-1(b)(8), Reg. §31.3121(a)(2)-1.

[313] Rev. Rul. 61-146 (reimbursements by employer to employees for employer's share of premiums for hospital and medical insurance may be considered employer contributions to accident or health plans, excludible under §106). *See* Rev. Rul. 2002-3 (employer reimbursement of salary reduction amounts paid by employer for health insurance coverage that were excluded from gross income under §106(a) are includible in employees' gross income and subject to employment taxes when there is no employee-paid premium for employer to reimburse), *amplified by* Rev. Rul. 2002-80 (exclusion from gross income under §105(b) does not apply to amounts employer pays to employee as advance reimbursements or loans regardless of whether or not employee incurs unreimbursed medical expenses). In Rev. Rul. 2003-43, the IRS provided guidance regarding the tax implications under §105(b) when an employer uses debit or credit cards and other electronic media to make reimbursements under a health reimbursement arrangement (HRA) or health flexible spending account (FSA), and methods and procedures for substantiating expenses. The IRS ruled that electronic reimbursement systems that substantiate claims for medical expenses meet the requirements of §105(b). Systems that do meet the requirements of §105(b) result in all payments provided by the cards being included in the participant's income. Notice 2006-69 amplified Rev. Rul. 2003-43 by clarifying the substantiation methods and requirements that apply to all medical reimbursement plans whether or not a card is used, and by providing guidance on the use of electronic reimbursement systems to reimburse participants in dependent care assistance programs (DCAPs), including dependent care FSAs. In Notice 2008-104 and Notice 2007-2, the IRS provided transition relief as to the use of debit cards for medical expense reimbursements at certain merchants with non-health-care-related merchant category codes and at drug/pharmacy stores. For further discussion of employer reimbursements of medical expenses, see 330 T.M., *Tax and ERISA Implications of Employer-Provided Medical and Disability Benefits.*

[314] As *amended by TCJA,* Pub. L. No. 115-97, §13221, effective for taxable years beginning after December 31, 2017.

[315] Reg. §1.451-2.

[316] *See* Reg. §31.3401(c)-1 (defining an "employee" as a person performing services in an employer-employee relationship). Full-time life insurance agents are included within the definition of employee. §7701(a)(20). *See* Rev. Rul. 56-400; Rev. Rul. 85-121; and Rev. Rul. 82-196 (ruling that tax benefits of §105 and §106 are available to employee's spouse and dependents before and after the employee's retirement and to the surviving spouse and dependents of a deceased employee). *See also* Rev. Proc. 2008-48 (circumstances under which IRS will treat a child of parents who are divorced, separated or living apart as the dependent of both parents for purposes of §105(b) and §106(a), among other provisions).

[317] §213(a), as amended by the ACA, Pub. L. No. 111-148, §9013. For taxable years beginning in 2017, 2018, 2019 and 2020, the medical expense deduction "floor" is temporarily reduced from 10% of adjusted gross income to 7.5% of AGI for all individuals. §213(f). The 7.5% floor also applies for the alternative minimum tax computation during these years. *See* former §56(b)(1)(B), as amended by TCJA, Pub. L. No. 115-97, §11027(b), effective for taxable years beginning after December 31, 2016, before removal by Pub. L. No. 116-94, Div. Q, §103(b).

[318] The exclusion from gross income of amounts received under accident and health plans covers amounts paid to the taxpayer to reimburse expenses incurred for medical care of any child (as defined in §152(f)(1)) of the taxpayer who was under age 27 at the end of the taxable year. §162(l)(1), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §1004(d)(2), effective March 30, 2010. *See* Notice 2010-38. Prior to 2003, the applicable percentage of amount paid for health insurance that could be deducted by a self-employed individuals was 70% for 2002 and 60% for 1999 through 2001. Former §162(l)(1)(B), as amended by Pub. L. No. 105-277, §2002. A self-employed individual who operates as a sole proprietor and purchases health insurance in his or her own name, instead of the name of the trade or business, may take the deduction from the earned income of the trade or business and does not aggregate the profits and losses of multiple businesses to establish the net income ceiling for deduction of insurance costs. CCA 200524001.

[319] §105(g).

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a. Insured Plans

An insured plan is a plan underwritten by a policy of insurance or a prepaid health care plan that involves the shifting of risk to an unrelated third party.[320] A plan that does not involve the requisite shifting of risk, such as a cost-plus policy or a policy that in effect merely provides administrative or bookkeeping services, is a self-insured plan (discussed below). Captive insurance companies can provide coverage that is insured, but only if premiums paid by unrelated employers are at least half of the total premiums received and the policy is similar to those sold to such unrelated companies.[321]

Before comprehensive healthcare reform legislation was enacted in 2010, no benefits-related, nondiscrimination rules applied in the case of an insured accident and health plan. In the absence of any applicable nondiscrimination rule, there could be no tax penalty for improperly excluding common law employees that might otherwise be covered under the terms of the plan. An improperly excluded common law employee, however, might still have had an ERISA-based claim. When it first enacted the nondiscrimination provisions of §105(h) for self-insured medical reimbursement plans, Congress was of the view that insurance underwriting considerations generally preclude or effectively limit abuses in insured plans. As a result of advances in insurance underwriting and increasing competition in the health insurance markets, Congress later came to view the matter differently.[322] Section 1151 of Tax Reform Act of 1986 (TRA '86)[323] added §89, which established a comprehensive set of nondiscrimination rules that applied to a broad range of welfare and fringe benefit plans including employer-provided group-term life insurance plans and accident and health plans (dependent care plans were subject to special rules). In 1989, the Treasury issued a proposed regulation interpreting the new nondiscrimination standards.[324] Section 89 was the subject of intense criticism. Despite some delays in the effective dates[325] and in spite of an earnest attempt at simplification, intense lobbying pressure particularly by small business interests ultimately doomed the measure. Section 89 was repealed by Title II of the Debt Limit Extension Act,[326] the proposed rules were repealed and the prior rules were reinstated.

Public Health Service Act (PHSA) §2716[327] extended for the first time the nondiscrimination requirements of §105(h)(2), which bar discrimination on the part of self-funded medical reimbursement plans based on eligibility or benefits, to insured group health plans. The provision also directed the regulators to establish rules similar to the ancillary provisions found in §105(h)(3) (relating to nondiscriminatory eligibility), §105(h)(4) (relating to nondiscriminatory benefits) and §105(h)(8) (applying the rules to controlled groups). It is up to the Departments of the Health and Human Services, Labor and Treasury to write rules implementing this new nondiscrimination standard. In Notice 2011-1, the Service postponed application of these rules until plan years beginning a specified period after issuance of regulations.[328]

Once the provisions of PHSA §2716 take effect, nondiscrimination rules will apply to both self-funded and fully insured plans. But the consequences of violating these standards differ significantly. As explained below, violations of §105(h) trigger income inclusion. In contrast, an insured group health plan that fails to comply with the insurance nondiscrimination rules under PHSA §2716 is subject to an excise tax under §4980D of $100 per day with respect to each individual to whom such failure relates.[329] Both Notice 2010-63 and Notice 2011-1 assume that the penalty is calculated based on the number of individuals discriminated against. Section 4980D(d) exempts small employers (i.e., employers with at least 2 and no more than 50 employees on business days during the preceding calendar year and who employ at least two employees on the first day of the plan year) from the $100-per-day penalty, but only where the failure is solely because of the health insurance coverage offered by such issuer.[330] While the penalty may be abated in instances where the failure is due to reasonable cause and not to willful neglect,[331] because plan design is more often than not a deliberate act, this exception may be of limited use. In addition, under ERISA, participants who are discriminated against may have a civil claim to enjoin a noncompliant act or practice or for other appropriate equitable relief.

b. Self-Insured Plans

Self-insured medical expense reimbursement plans are subject to the nondiscrimination requirements set out in §105(h) of the I.R.C. The exclusion from income provided under §105(h) is totally or partially denied to highly compensated individuals who are covered under a self-insured medical reimbursement plan that discriminates as to either eligibility (under §105(h)(3)) or benefits (under §105(h)(4)). When a self-insured medical reimbursement plan fails the nondiscrimination requirements of §105(h)(3) or §105(h)(4), benefits paid to highly compensated individuals become taxable in whole or in part. A benefit paid to a highly compensated individual that is not available to all other participants is not excludible under §105(b).[332] Where a benefit is paid to a highly compensated in-

[320] Reg. §1.105-11(b)(1)(ii).

[321] Reg. §1.105-11(b)(1)(iii).

[322] *See General Explanation of the Tax Reform Act of 1986 ("Blue Book")*, Prepared by the Staff of the Joint Committee on Taxation, 780–81 ("Under prior and present law, the tax-favored treatment of employer-provided employee benefits reduces the Federal income tax base and reduces Federal budget receipts. However, Congress believed that the costs are justifiable if such benefits fulfill important social policy objectives, such as increasing health insurance coverage among taxpayers who are not highly compensated and who otherwise would not purchase or could not afford such coverage. In order to achieve these objectives, Congress believed that effective nondiscrimination rules with respect to all employee benefit plans, including health insurance, were necessary because they permit the exclusion from income of employee benefits only if the benefits are provided to required levels of non-highly compensated employees.").

[323] Pub. L. No. 99-514.

[324] Prop. Reg. §1.89-1.

[325] The IRS postponed enforcement several times, and the Treasury, Postal Service, and General Government Appropriations Act, Pub. L. No. 101-136, prohibited the use of government funds to enforce §89 in the 1990 fiscal year.

[326] Pub. L. No. 101-140, §203(b)(2).

[327] Added by Pub. L. No. 111-148, §1001(5), and amended by §10101(d), effective for plan years beginning on or after September 23, 2010 (pursuant to Pub. L. No. 111-148, §1004(a)).

[328] Notice 2011-1, §II.

[329] §4980D(b)(1).

[330] §4980D(d)(1).

[331] §4980D(c)(2)(A).

[332] Reg. §1.105-11(e)(2).

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dividual in an amount that is greater than that available to any other participant, the excess is taxed to the highly compensated individual.[333] Section 105(h)(5) defines highly compensated individual to mean (1) one of the five highest paid officers,[334] (2) a shareholder who owns (with the application of §318) more than 10% in value of the stock of the employer, or (3) among the highest paid 25% of all employees. This determination is made on a controlled and affiliated service group basis.[335]

The eligibility requirements of §105(h)(3) are similar to the nondiscrimination rules that applied to tax-qualified pension, profit sharing and stock bonus plans under §410(b) prior to TRA '86. Under those rules, the plan must benefit either (1) 70% or more of all employees, or 80% or more of all employees who are eligible to benefit under the plan if 70% or more of all employees are eligible to benefit under the plan, or (2) a classification of employees set up by the employer and found by the Secretary of the Treasury not to be discriminatory in favor of highly compensated individuals.[336] Under §105(h)(4), a plan generally must provide benefits on a nondiscriminatory basis. Benefits provided to highly compensated individuals (and their dependents) also must be provided to all other participants.[337] Discrimination is determined by looking at the benefits available under the plan rather than the amounts paid.

For purposes of applying these tests, §105(h)(3)(B) allows employers to exclude the following: (1) employees who have not completed three years of service;[338] (2) employees who have not attained age 25; (3) part-time or seasonal employees;[339] (4) employees covered by a collective bargaining agreement, if accident and health benefits were the subject of good faith bargaining between employee representatives and the employer or employers;[340] and (5) employees who are nonresident aliens and receive no earned income.

If an employer misclassifies a common law employee as an independent contractor and excludes that individual from participation in the employer's self-insured medical reimbursement plans as a result, the plan might be discriminatory causing taxable reimbursements to highly compensated individuals. Reimbursements in excess of those permitted under the applicable nondiscrimination rules are taxable as income, but not subject to income tax withholding or employment taxes.[341] Such a violation is likely to involve the eligibility requirements of §105(h)(3). When a plan fails the eligibility test, a portion of the benefits paid with respect to highly compensated individuals is an excess reimbursement that is not excludible. That portion is determined by multiplying the total amount reimbursed to an employee by a fraction. The numerator of the fraction is the total amount reimbursed during that plan year to all highly compensated individuals, and the denominator is the total amount reimbursed during that plan year to all participants.[342] This exposure could be quite serious.

Example: During the 2016 plan year, Employee D, a highly compensated individual, was hospitalized for coronary bypass surgery and incurred medical expenses of $125,000 that were reimbursed to D under the plan. During that plan year the Corporation P medical plan paid $500,000 in benefits under the plan in the aggregate, $300,000 of which constituted benefits paid to highly compensated individuals. The amount of excess reimbursement not excludible by D under §105(b) is $75,000 [$125,000 × (300,000/500,000) = $75,000]. This example is far-fetched because self-insured plans typically cover larger participant populations, and the applicable nondiscrimination tests leave some room for error. Moreover, in a large plan, the ratio of reimbursements for highly compensated individuals to total reimbursements is relatively smaller. But consider an employer with 2,000 workers that are organized into two divisions. Division 1 has 1,100 workers that are covered under the employer's self-insured medical reimbursement plan. The 900 workers in Division 2 are leased through a staffing agency, and they are not covered under the employer's medical plan. Assume that the leased employees are the employer's lowest paid workers and that they are determined to be common law employees when the *Darden* factors are applied. Under §105(h), the highest paid 500 of the Division 1 employees (i.e., 25% of the employer's 2,000 common law employees) are highly compensated individuals, and the plan will discriminate as to eligibil-

[333] Reg. §1.105-11(e)(1).

[334] The regulations under §105 furnish no guidance on who qualifies as an officer. *Cf.* Reg. §1.414(c)-3(d)(3) ("[T]he term 'officer' includes the president, vice-presidents, general manager, treasurer, secretary, and comptroller of a corporation, and any other person who performs duties corresponding to those normally performed by persons occupying such positions"); Reg. §1.416-1, Q&A T-13 ("Whether an individual is an officer shall be determined upon the basis of all the facts, including, for example, the source of his authority, the term for which elected or appointed, and the nature and extent of his duties. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes those employed for a special and single transaction. An employee who merely has the title of an officer but not the authority of an officer is not considered an officer for purposes of the key employee test. Similarly, an employee who does not have the title of an officer but has the authority of an officer is an officer for purposes of the key employee test…").

[335] §105(h)(8), §414(b), §414(c), §414(m).

[336] Reg. §1.105-11(c)(2)(ii). This determination is based on the facts and circumstances of each case, applying the same standards as were applied under §410(b)(1)(B) before 1989 without regard to §410(a)(5). The nondiscriminatory classification test of §410(b) cannot, of course, be applied exactly. Rather, it needs to be modified to take into account the particular categories of excludible employees, and the specific definition of "highly compensated individual" contained in §105(h). The IRS will not issue a letter ruling or determination letter regarding whether a self-funded health plan satisfies the nondiscrimination tests for a plan year. Rev. Proc. 2025-3, §3.01(21).

[337] Reg. §1.105-11(c)(3)(i).

[338] Reg. §1.105-11(c)(2)(iii)(A) provides that years of service may be determined by any method that is reasonable and consistent. The IRS crediting rules of §410(a)(3) may be used.

[339] Reg. §1.105-11(c)(2)(iii)(C) contains a general rule and exception for part-time and seasonal employees. Under the general rule, part-time employees customarily work less than 35 hours per week, if other employees in similar work with the same employer (or, if no employees of the employer are in similar work, in similar work in the same industry and location) have substantially more hours. Seasonal employees are those whose customary annual employment is less than nine months, if other employees in similar work with the same employer (or, if no employees of the employer are in similar work, in similar work in the same industry and location) have substantially more months. Under the exception, any employee whose customary weekly employment is less than 25 hours or any employee whose customary annual employment is less than seven months may be considered as a part-time or seasonal employee.

[340] This provision is similar to that found in §410(b)(3)(A). Section 7701(a)(46) excludes from the definition of "employee representatives" any organization "more than one-half of the members of which are employees who are owners, officers, or executives of the employer." *See* Reg. §301.7701-17T.

[341] §3401(a)(20), §3121(a)(2)(B).

[342] Reg. §1.105-11(e)(3).

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ity. To make matters worse, if the plan covers "all employees" of the employer rather than just Division 1 employees, then the excluded workers may have a claim for benefits under ERISA §502(a)(3); they may be able to assert a claim for fiduciary breach under ERISA §502(a)(2); and if they can demonstrate that their exclusion was intended to deprive them of benefits, they may also have a claim under ERISA §510. In a situation such as this, *Microsoft* inoculation language might stem the ERISA claims, but even this is not certain because it is not clear that the DOL or the courts would agree with the IRS's position in this regard.[343]

For a detailed discussion of accident and health plans, see 330 T.M., *Tax and ERISA Implications of Employer-Provided Medical and Disability Benefits.*

3. Cafeteria Plans (§125)

As described in III.E.2. (with respect to accident and health plans), §106 excludes from the gross income of employees, employer contributions to an accident or health plan. When employer-financed benefits are paid to or on behalf of an employee, such payments are excluded from gross income under §105(b). Accident and health benefits attributable to after-tax employee contributions generally are excludible from income under §104(a)(3). Section 106 first appeared in the I.R.C. in 1954 when the vast majority of employer-sponsored accident and health plans were entirely employer-financed. Plans requiring employees to contribute to the costs of coverage came later. It was not until 1978, with the enactment of §125, that employee contributions to accident and health plans became deductible.[344]

Section 125(d)(1) defines a cafeteria plan as a written plan under which — (A) *all participants are employees*, and (B) the participants may choose among two or more benefits consisting of cash and qualified benefits. The definition of employee for this purpose is found in Reg. §31.3401(c)-1, i.e., an individual performing services in an employer-employee relationship. The definition is expanded by §7701(a)(20), which reaches certain full-time life insurance agents, and by §414(n)(3)(C), that adds leased employees within the meaning of §414(n)(2). Self-employed individuals, partners, and 2% shareholders of S corporations are excluded. A plan that erroneously covers workers who are not employees is not a cafeteria plan, and the tax benefits are lost to all participants as a result.

Comment: Many PEOs offer a broad range of employee benefits, including a §125 cafeteria plan, to workers that they describe as being co-employees of the PEO and the recipient. As described at length in IV.B.3., the I.R.C. does not recognize co-employment. If these workers are determined to be the common law employees of the recipient, all employee contributions are likely taxable.

Under §125(b)(1), a cafeteria plan cannot discriminate in favor of highly compensated individuals as to eligibility to participate or highly compensated participants as to contributions and benefits. Section 125(e)(1) and §125(e)(2) define the term "highly compensated individual participant" and "highly compensated individual" to mean (1) an officer, (2) a shareholder owning more than 5% of the voting power or value of all classes of stock in the employer, (3) highly compensated,[345] or (4) a spouse or dependent of such an individual. Section 125(b)(2) provides that qualified benefits provided to key employees under the plan may not exceed 25% of the aggregate of such benefits provided for all employees under the plan. The term "key employee" is defined in §416(i)(1).

Not all employees must be covered, however. Section 125(g)(3) provides that the eligibility rules will be treated as satisfied if (1) a plan covers at least a nondiscriminatory classification of employees; (2) no employee is required to complete more than three years of employment with the employer or employers maintaining the plan; and (3) the employment requirement for each employee is the same. An employee who satisfies the service requirement and is otherwise entitled to participate in the plan must commence participation no later than the first day of the first plan year beginning after the date the employment requirement was satisfied, unless the employee was separated from service before then. The reasonable classification test that applies to cafeteria plans is the same reasonable classification test found in §410(b)(2)(A)(i).[346] Section 125(g)(1) contains an exception under which a cafeteria plan will not be deemed to be discriminatory if it is maintained under a collective bargaining agreement. Under a special rule that applies to health benefits, a cafeteria plan is not treated as discriminatory as to benefits under §125(b)(1)(B) if (A) contributions under the plan on behalf of each participant include an amount which — (i) equals 100% of the cost of the health benefit coverage under the plan of the majority of the highly compensated participants similarly situated, or (ii) equals or exceeds 75% of the cost of the health benefit coverage of the participant (similarly situated) having the highest cost health benefit coverage under the plan, and (B) contributions or benefits under the plan in excess of those described in (A) bear a uniform relationship to compensation."[347]

Where workers are erroneously excluded from cafeteria plan participation, the risk is that the calculations underlying

[343] *Cf.* Reg. §1.105-11(e)(4) *Ex.* 4. *See* III.B.4. (discussing the unreleased July 28, 1999, Technical Advice Memorandum).

[344] §125 was added to the I.R.C. by the Revenue Act of 1978, Pub. L. No. 95-600, §134(a). The ACA made several changes affecting cafeteria plans. For a detailed discussion of these changes, see 335 T.M., *Health Care Reforms — Implications for Employee Benefit Plans*, and 397 T.M., *Cafeteria Plans. See* Reg. §1.125-3 and §1.125-4; Prop. Reg. §1.125-1 through §1.125-2 and §1.125-5 through §1.125-7, proposed to apply for plan years beginning on or after January 1, 2009, but taxpayers may rely on the proposed regulations for guidance pending the issuance of final regulations (REG-142695-05, 72 Fed. Reg. 43,938 (Aug. 6, 2007)).

[345] §125(j)(3)(D)(iii) referencing §414(q).

[346] See Prop. Reg. §1.125-7(b)(1), proposed to apply for plan years beginning on or after January 1, 2009, but taxpayers may rely on the proposed regulations for guidance pending the issuance of final regulations. Although many fringe benefit plans under the I.R.C. contain a reasonable classification test, §125(g)(3) is the only instance where the post-TRA '86 reasonable classification test is referenced. *See* §79(d)(3)(A)(iii) (relating to group term life insurance), §105(h)(3)(A)(ii) (relating to self-insured medical reimbursements), §117(d)(3) (relating to qualified tuition assistance), §127(b)(2) (relating to educational assistance plans), §129(d)(3) (relating to dependent care assistance), §132(j)(1) (relating to certain fringe benefits), and §505(b)(1) (relating to VEBAs). This is likely due to the timing of the enactment of the statutes.

[347] §125(g)(2). See Prop. Reg. §1.125-7(e), proposed to apply for plan years beginning on or after January 1, 2009, but taxpayers may rely on the proposed regulations for guidance pending the issuance of final regulations.

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these nondiscrimination tests will be affected. An employer that maintains a cafeteria plan and also has a large cohort of freelancers who are not included in cafeteria plan testing due to the employer's assumption that the freelancers are independent contractors will be at risk if the freelancers are later determined to be common law employees. Smaller employers are particularly susceptible in this regard because the results of the numerical tests set out in §410(b)(2)(A)(i) can be adversely affected by small changes in the relative number of workers included and excluded.

Example: An incorporated medical practice has four physicians — A, B, C and D — each of whom is a highly compensated employee within the meaning of §414(q). Only A and B are key employees. The practice has one secretarial assistant, E, who is non-highly compensated, and it also retains the services of three nurse practitioners: F, G and H. The practice has for years treated F, G and H as independent contractors. On audit, the IRS, applying the *Darden* factors, determines that F, G and H are common law employees. Under Reg. §1.410(b)-4, the non-highly compensated employee concentration percentage is 25% [1/4 = 25%]; the safe harbor percentage is 50% and the unsafe harbor percentage is 40%. The plan's ratio percentage is 25% [25%/100%], which is less than the plan's unsafe harbor percentage of 40%. The result is that amounts deferred under the plan by A, B, C, and D will be taxable for the open years. E is unaffected. The excluded individuals — F, G and H — do not gain any substantive rights as a result of the failure of the plan to cover a reasonable classification of employees. If only one of the nurse practitioners had been treated as an employee and covered under the plan, the plan's non-highly compensated employee concentration percentage would be 50%; the safe harbor and unsafe harbor percentages would remain the same; and the ratio percentage would rise to 50%, which is equal to the safe harbor percentage. The plan would therefore pass the ratio percentage test.

In addition to the nondiscrimination tests imposed by §125, each benefit furnished pursuant to a cafeteria plan also must pass its own particular nondiscrimination tests. For a detailed discussion of cafeteria plans, see 397 T.M., *Cafeteria Plans.*

4. Educational Assistance Programs (§127)

Section 127 provides that the gross income of an employee does not include amounts paid or expenses incurred by the employer for educational assistance to the employee if the assistance is furnished pursuant to a program that benefits employees who qualify under a nondiscriminatory classification. The exclusion from income is limited to $5,250 (indexed for taxable years beginning after 2026),[348] but all or part of any excess may be deductible as a working condition fringe benefit (discussed in III.E.9.f.). Amounts received under an educational assistance plan also are exempt from employment taxes and income tax withholding. For §127 purposes, an employee is a common law employee and includes (1) a former employee who has retired or terminated his or her service as a result of disability, (2) a present employee on leave, (3) a self-employed individual within the meaning of §401(c)(1), and (4) a leased employee with the meaning of §414(n).[349] Educational assistance means amounts paid or incurred for an employee's educational expenses. Educational assistance includes books, equipment, fees and tuition of employee education, including graduate-level education. It also includes payments made by an employer after March 27, 2020, to an employee or a lender for principal or interest on the employee's qualified education loan. Educational assistance does not include payment for or provision of tools or supplies that may be retained by the employee after completion of the course of instruction, or meals, lodging or transportation, or the costs of a course involving sports, games or hobbies.[350]

The employees eligible for the plan must be a nondiscriminatory classification set up by the employer and found by the IRS not to be discriminatory in favor of highly compensated employees within the meaning of §414(q).[351] Whether a classification is nondiscriminatory in favor of highly compensated individuals is generally determined by applying the same standards as are applied under the qualified plan rules of §410(b)(1)(B).[352] Under those rules, if the plan benefits a percentage of employees who are non-highly compensated that is at least 70% of the percentage of employees who are highly compensated, the plan is considered nondiscriminatory. Excluded from consideration are employees who are not included in the program and are included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and the employer, but only if there is evidence that educational assistance benefits were the subject of good faith bargaining between the employee representatives and the employer.[353]

To qualify, an educational assistance program must be set forth in a separate written plan that is for the exclusive benefit of employees, and no more than 5% of the amounts paid or incurred by the employer for educational assistance during the year may be provided for the class of individuals who are shareholders or owners (or their spouses or dependents), each of whom (on any day of the year) owns more than 5% of the stock, capital or profits interest in the employer.[354] A program must not provide eligible employees with a choice between educational assistance and other remuneration includible in gross income.[355]

[348] §127(a)(2); §127(d) (inflation adjustment), added by the OBBBA, Pub. L. No. 119-21, §70412(b)(2), effective for payments made after December 31, 2025.

[349] §127(c)(2); Reg. §1.127-2(d) and §1.127-2(h)(1). *See* §414(n)(3)(C).

[350] §127(c)(1), as amended by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136, §2206 (adding student loan payments), the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Div. EE of the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, §120(a) (5-year extension), effective for payments made after December 31, 2020, and the OBBBA, Pub. L. No. 119-21, §70412(a) (removing clause that limited student loan payments to pre-January 1, 2026 payments), effective for payments made after December 31, 2025; Reg. §1.127-2(c)(1) and §1.127-2(c)(3).

[351] §127(b)(2).

[352] Reg. §1.127-2(e).

[353] §127(b)(2).

[354] §127(b)(1), §127(b)(3).

[355] §127(b)(4).

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Erroneously covering an independent contractor under an educational assistance program violates the requirement that programs be for the exclusive benefit of employees and results in the loss of tax benefits for all participants, not just the prohibited group. Where common law employees are excluded, then the concern is the extent to which the exclusion affects the applicable nondiscrimination tests. If the plan is unable to pass such tests when the excluded workers are considered, then §127(a)(1) requires that all employees that receive tuition assistance must include it in income for the open tax years.

5. Dependent Care Assistance Programs (§129)

Section 129 provides an exclusion from gross income of the employee for amounts paid or incurred by the employer for dependent care assistance provided to the employee if the assistance is furnished pursuant to a dependent care assistance program (DCAP). Specifically, an employee may exclude: (1) the value of services provided to the employee; (2) the amount directly paid to the provider of dependent care assistance; or (3) the amount reimbursed to the employee for expenses incurred for dependent care assistance under a DCAP.[356] The exclusion cannot exceed $7,500 (or $3,750 for married individuals filing separately) for tax years beginning after 2025 or $5,000 (or $2,500 for married individuals filing separately) for tax years beginning befre 2026 (except 2021), nor can the exclusion be more than the earned income of the employee or the employee's spouse if the employee is married at the end of the taxable year.[357] For a tax year beginning during 2021, however, the exclusion cannot exceed $10,500, or $5,250 for married individuals filing separately.[358] Also, §129(c) prohibits certain payments to related individuals. An employee includes a current common law employee, a leased employee within the meaning of §414(n), a sole proprietor, or a partner who performs services for a partnership.[359]

Section 129(e)(1) defines dependent care assistance as the payment of, or provision of, those services, which if paid for by the employee would be considered employment-related expenses under §21(b)(2) relating to the dependent care credit. Services may be incurred either inside or outside the employee's home, but if they are incurred for services outside the home, then the services must be provided to either a dependent of the employee under age 13 or a spouse or dependent of an employee who is physically or mentally incapable of caring for himself or herself and spends at least one half of the taxable year in the same principal place of abode as the employee.[360]

Section 129(d)(1) requires that a dependent care assistance program be a separate written plan of the employer for the exclusive benefit of the employees. Contributions or benefits provided under the plan may not discriminate in favor of highly compensated employees within the meaning of §414(q) or their dependents.[361] The eligibility test of §129(d)(3) requires that the program benefit employees who qualify under a nondiscriminatory classification of employees. For purposes of applying these tests, employees who have not attained age 21 and completed one year of service can be excluded, as can employees covered by certain collective bargaining agreements if there is evidence of good faith bargaining.

Under §129(d)(4), not more than 25% of the amounts paid or incurred by the employer for dependent care assistance during the year may be provided for the class of individuals who are 5% shareholders or owners (or their spouses or dependents).

Section 129(d)(5) provides that funding is not required for these programs. Employees must be notified of the availability and terms of the program and must be provided with a written statement annually as of the last day of January, showing the amounts paid or expenses incurred by the employer in providing dependent care assistance to the employee during the previous calendar year.[362] This information also must appear on the employee's Form W-2.

Section 129(d)(8)(A) requires that the average benefits provided for dependent care assistance to all non-highly compensated employees be at least 55% of the average benefits provided to all highly compensated employees.

Comment: Section 21(a) provides taxpayers with an income tax credit for certain dependent care expenses designed to enable taxpayers to be gainfully employed. Under §21(c), the amount of expenses incurred during the tax year that may be taken into account is $3,000 in the case of a single qualifying individual or $6,000 for two or more qualifying individuals. The percentage of dependent care expenses that are available for the credit varies inversely with a taxpayer's income. The credit phases out at $43,000, except for tax years beginning in 2021. For tax years beginning after December 31, 2025, the maximum credit amount is 50%, phasing down to 35%, and further reduced by 1% for each $2,000 in the case of a single qualifying individual or $4,000 for two or more qualifying individuals or fraction thereof when the individual's adjusted gross income for a taxable year exceeds $75,000 or $150,000 in the case of a joint return, the additional reduction not to exceed 20%.[363] For tax years beginning on or before December 31, 2025, the maximum credit amount is 35%, phasing down to 20%. These amounts reflect changes made in 2001 to make the dependent care tax credit more valuable to a broader range of workers. Because the dependent care tax credit under §21 competes with the income tax exclusion for dependent care expenses under §129, and the tax credit generally is more favorable to lower-income taxpayers, §129(d)(8)(B) allows plan sponsors to exclude employees with incomes less than $25,000 when performing the nondiscrimination tests required under §129(d)(8). This $25,000 amount is not adjusted for cost of living increas-

[356] See Notice 2006-69, §V, for guidance on the use of debit cards, credit cards or stored value cards to reimburse participants in DCAPs, including dependent care flexible spending arrangements.

[357] §129(a)(2)(A), as amended by the OBBBA, Pub. L. No. 119-21, §70404, effective for taxable years beginning after December 31, 2025, and §129(b). *See* §21(b)(2)(B); Reg. §1.21-1(e)(1) in the case of a spouse who is a student or disabled.

[358] §129(a)(2)(D), added by the American Rescue Plan Act of 2021, Pub. L. No. 117-2, §9632(a), effective for taxable years beginning after December 31, 2020. The plan may be amended retroactively to increase this cap if certain conditions are satisfied. *See* Pub. L. No. 117-2, §9632(c).

[359] *See* §129(e)(3), §414(n)(3)(C).

[360] Reg. §1.21-1(b).

[361] §129(d)(2).

[362] §129(d)(6), §129(d)(7).

[363] §21(a)(2), as amended by the OBBBA, Pub. L. No. 119-21, §70405 (increasing the credit amount and modifying calculation), effective for taxable years beginning after December 31, 2025.

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es.[364] Special rules apply for a tax year beginning during 2021. The credit is refundable for eligible taxpayers with a principal place of abode in the United States for more than half of the tax year.[365] The amount of the credit is up to 50% (the "applicable percentage") of a specified amount of eligible expenses, which is $8,000 for a single qualifying individual and $16,000 for two or more. The applicable percentage is reduced by one percentage point for each $2,000 (or fraction thereof) by which the taxpayer's adjusted gross income exceeds $125,000, but not below the "phaseout percentage."[366] The phaseout percentage equals 20%, reduced (but not below zero) by one percentage point for each $2,000 or fraction thereof by which the taxpayer's adjusted gross income exceeds $400,000.[367]

If a program qualifies as a dependent care assistance program but fails to meet these requirements in operation, then the benefits are taxable to highly compensated employees. Dependent care payments or reimbursements by the employer will not be subject to federal income tax withholding, or included in wages for FICA or FUTA tax purposes.[368]

Independent contractors working for a business are denied the income tax benefits afforded by §129. This means that the income is taxable and subject to employment taxes and income tax withholding. Where the improper exclusion of common law employees results in a testing failure, highly compensated employees must take dependent care assistance amounts into income for open tax years. Non-highly compensated employees are unaffected.[369]

Because of the Covid-19 pandemic, Congress provided a special carryover rule and an extended grace period for contributions to dependent care assistance programs and health FSAs.[370]

See 513 T.M., *Family and Household Transactions*, for a comprehensive discussion of the dependent care tax credit. See 397 T.M., *Cafeteria Plans*, for a discussion of DCAPs.

6. Adoption Assistance Programs (§137)

Under §137, gross income of an employee does not include amounts paid or expenses incurred by the employer for qualified adoption expenses in connection with the adoption of a child by an employee provided such amounts are furnished pursuant to an adoption assistance program. For purposes of §137, employee includes current common law employees, and leased employees within the meaning of §414(n).

An adoption assistance program is defined as a separate written plan of an employer for the exclusive benefit of its employees that provides for adoption assistance and meets certain other requirements. The term qualified adoption expenses is defined in §23(d) to mean (subject to certain limits) reasonable and necessary adoption fees, court costs, attorney fees, and other expenses directly related to (and with the principal purpose of) the legal adoption of an eligible child by the employee. An eligible child is a child who is under age 18 or physically or mentally incapable of self-care when the expense is paid or incurred.

The maximum amount, as adjusted for inflation, that can be excluded from an employee's gross income in connection with the adoption of a child, with or without special needs, is $10,000, as adjusted for inflation.[371] Under §137(b)(2)(A), the exclusion is phased out for taxpayers with modified adjusted gross income of $150,000, as adjusted for inflation.[372] Section 137 was scheduled to expire and extended several times, until it was made permanent for tax years beginning after December 31, 2012.[373]

Section 137(c)(2) incorporates the eligibility or nondiscrimination requirements of §127(b)(2) (eligibility — the plan must benefit a nondiscriminatory classification of employees), §127(b)(3) (benefits payable to 5% shareholders or owners cannot exceed 5% of the benefits payable under the plan during a year), §127(b)(5) (no requirement of advance funding) and §127(b)(6) (the plan must be disclosed to all eligible employees). Adoption assistance may be provided under a cafeteria plan, in which case the program is subject to the nondiscrimination rules that apply generally under §125.

Because adoption assistance plans are available only to employees, benefits provided in error to a non-common law employee will be taxable for all open tax years. Where common law employees are excluded from an adoption assistance plan and the program fails the eligibility or principal shareholder rules similar to the requirements of §127(b)(2) and §127(b)(3), the plan will fail and all employees receiving adoption assistance will have taxable benefits. If the adoption program is offered under a cafeteria plan and those discrimination rules are failed, there can be a loss of tax benefits to highly compensated employees.

See 397 T.M., *Cafeteria Plans*, for a discussion of adoption assistance programs.

7. Voluntary Employees' Beneficiary Associations

ERISA §201 exempts welfare benefit plans from participation and vesting rules and §301 exempts welfare benefit plans

[364] EGTRRA, Pub. L. No. 107-16, §204. Changes made by EGTRRA §204 were due to sunset after 2012. Pub. L. No. 107-16, §901, as amended by Pub. L. No. 111-312, §101(a). The American Taxpayer Relief Act of 2012 (ATRA), Pub. L. No. 112-240, §101, permanently extended the EGTRRA changes, effective for taxable years beginning after December 31, 2012.

[365] §21(g)(1), added by the American Rescue Act of 2021, Pub. L. No. 117-2, §9631(a), effective for taxable years beginning after December 31, 2020.

[366] §21(g)(2), §21(g)(3), added by Pub. L. No. 117-2, §9631(a).

[367] §21(g)(4), added by Pub. L. No. 117-2, §9631(a).

[368] §3401(a)(18), §3121(a)(18), §3306(b)(13).

[369] §129(d)(1).

[370] Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, Div. EE, §214. For a detailed discussion of these special rules, see 397 T.M., *Cafeteria Plans.*

[371] §137(a)(2), §137(b)(1), and §137(f), as amended by the ACA, Pub. L. No. 111-148, §10909(a)(2), and TCJA, Pub. L. No. 115-97, §11002(d)(1)(N) (reflecting change to §1(f)(3) inflation adjustment formula from CPI-U to chained CPI-U, applicable to taxable years beginning after December 31, 2017). *See* Pub. L. No. 111-148, §10909(c), as amended by Pub. L. No. 111-312, §101(b) (amendments to §137 increasing exclusion amount sunset after 2011). For the current and prior years' adjusted amounts, see Worksheet 11 of 394 T.M., *Employee Fringe Benefits.*

[372] For the current and prior years' adjusted amounts, see Worksheet 11 of 394 T.M., *Employee Fringe Benefits.*

[373] Former §137(f) terminated §137 for amounts paid or expenses incurred after 2001. Former §137(f) was stricken by EGTRRA, Pub. L. No. 107-16, §202(d)(2). This amendment was scheduled to expire after 2010, but was extended through 2012. Pub. L. No. 107-16, §901; Pub. L. No. 111-312, §101(a). ATRA, Pub. L. No. 112-240, §101, repealed the EGTRRA sunset provision (Pub. L. No. 107-16, §901), thereby making EGTRRA changes permanent.

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from ERISA's funding rules. While there is no statutory requirement to pre-fund welfare benefit promises, many employers do so either through a non-taxable voluntary employees' beneficiary association (VEBA) or through a taxable welfare benefit fund.[374] A VEBA is a tax-exempt trust or a corporation that provides for the payment of life, sickness, accident or other benefits to VEBA members or their dependents or their designated beneficiaries.[375] For an association to qualify as a VEBA, membership must be voluntary and composed of individuals who are employees. Reg. §1.501(c)(9)-2(a)(1) requires that members be individuals who become entitled to participate by *reason of their being employees* and whose eligibility for membership is defined by reference to objective standards that constitute an *employment-related common bond*. The term "employee" is defined for VEBA purposes in Reg. §1.501(c)(9)-2(b)(1) with reference to the employment tax rules or a collective bargaining agreement. The phrase "employment-related common bond" includes individuals who are not employees, but only within limits. Reg. §1.501(c)(9)-2(a)(1) provides, in pertinent part, that:

> Whether a group of individuals is defined by reference to a permissible standard or standards is a question to be determined with regard to all the facts and circumstances, taking into account the guidelines set forth in this paragraph. Exemption will not be denied merely because the membership of an association includes some individuals who are not employees (within the meaning of paragraph (b) of this section), provided that such individuals share an employment-related bond with the employee-members. Such individuals may include, for example, the proprietor of a business whose employees are members of the association. For purposes of the preceding two sentences, an association will be considered to be composed of employees if 90% of the total membership of the association on one day of each quarter of the association's taxable year consists of employees (within the meaning of paragraph (b) of this section).

Section 505(b)(1) provides that each class of benefits under a VEBA must (1) be provided to a nondiscriminatory classification of employees and (2) not discriminate in favor of highly compensated individuals with respect to each class of benefits. While there is no guidance as to what constitutes a nondiscriminatory classification in the VEBA context, §505(b)(2) does exclude (1) employees with less than three years of service, (2) employees who have not attained age 21, (3) seasonal or less-than-half-time employees, (4) collective bargaining unit employees (if benefits have been the subject of good faith bargaining), and (5) employees who are nonresident aliens with no U.S.-source earned income from the employer. There is no guidance as to how to calculate a year of service, nor is there any guidance as to what constitutes a seasonal or less-than-half-time employee. While there is no statutory cross-reference, the wording excluding collective bargaining employees is similar to that found in §410(b)(3)(A) with respect to tax-qualified retirement plans, so compliance with these provisions will probably suffice.[376] Section 505(b)(5) states that highly compensated employee is to be defined under rules similar to the rules of §414(q).

Although there is a separate rule that treats the payment of disproportionate benefits to highly compensated personnel as prohibited inurement,[377] life insurance, disability, severance pay, or supplemental unemployment compensation benefits may bear a uniform relationship to total compensation, or the basic or regular rate of compensation, of employees covered by the plan. But if a benefit provided under the VEBA has its own nondiscrimination provisions, then the nondiscrimination rules of §505(b) are not applied. Instead, the rules of the particular benefit apply. Thus, for example, a VEBA established for the purpose of funding a self-insured medical reimbursement plan is deemed to be nondiscriminatory so long as the requirements of §105(h) are satisfied.

Due in large part to the 90% rule of Reg. §1.501(c)(9)-2(a)(1), VEBAs have some room for error where worker classification issues are concerned. If non-common law employees occasionally are covered under a VEBA, then the VEBA's tax status should not be threatened. If these employees are included in large numbers, thereby resulting in a breach of the 90% threshold, the VEBAs status as a tax-exempt entity is at risk. Where common law employees are erroneously excluded, then the proper application of the various anti-inurement and nondiscrimination rules are called into question.

8. *Non-§6039D Fringe Benefits with Nondiscrimination Standards*

The fringe benefit plans discussed below are not subject to reporting requirements under §6039D but are subject to a separate set of nondiscrimination rules. Accordingly, the tax-related concerns, other than those that are reporting-related, apply equally to these plans. If a worker who is not an employee is covered, then he or she cannot take advantage of the tax benefits. If an employee is improperly excluded, then he or she may have claims for benefits, equitable remedies or even damages in the appropriate (i.e., non-ERISA) case, and the plan may

[374] Andrew Stumpff, *The Unimportance of Being a VEBA: Tax Attributes of Nonexempt Welfare Benefit Trusts*, 47 Tax Lawyer 113 (1993).

[375] §501(c)(9); Reg. §1.501(c)(9)-1. For purposes of paying sick and accident benefits to members of VEBAs, "dependent" includes a child (as defined in §152(f)(1)) of a member who is under age 27 at the end of the calendar year. §501(c)(9), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §1004(d)(4), effective March 30, 2010.

[376] *But see* 135 Cong. Rec. H8096 (Nov. 7, 1989) (Statement of Rep. Rostenkowski) ("[T]he Secretary should, where appropriate interpret the prior law rules relating to benefits under self-insured medical plans and group-term life insurance plans in a different manner than those rules that apply in the areas of qualified retirement plans, even where the statutory requirements with respect to such plans are similar.").

[377] Reg. §1.501(c)(9)-4(b) (providing rules regarding the payment of disproportionate benefits). The regulation provides: "[T]he payment to any member of disproportionate benefits, where such payment is not pursuant to objective and nondiscriminatory standards, will not be considered a benefit within the meaning of Reg. §1.501(c)(9)-3 even though the benefit otherwise is one of the type permitted by that section. For example, the payment of benefits to highly compensated personnel in disproportion to benefits received by other members of the association will constitute prohibited inurement. Also, the payment to similarly situated employees of benefits that differ in kind or amount will constitute prohibited inurement unless the difference can be justified on the basis of objective and reasonable standards adopted by the association or on the basis of standards adopted pursuant to the terms of a collective bargaining agreement." Reg. §1.501(c)(9)-4(b).

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have difficulty satisfying the applicable nondiscrimination tests once the workers are reclassified.

a. Qualified Achievement Awards — §74(c) and §274(j)

Under §74(c), an employee may exclude from income the value of any tangible personal property received as an award for either length of service or a safety achievement. The maximum amount that can be excluded under this provision is $1,600 for an award that is a qualified plan award.[378] A qualified plan award is defined in §274(j)(3)(B)(i) to mean an employee achievement award that is granted as part of an established written plan or program of the taxpayer and does not discriminate in favor of highly compensated employees (within the meaning of §414(q)) as to eligibility or benefits. Whether or not an achievement award plan is discriminatory is determined from all the facts and circumstances of the particular case. If the arrangement is determined to be discriminatory, the employer deduction and the income exclusion for the employee generally is limited to $400.[379] The nondiscrimination test that applies in this instance is not tied to any other statutory or regulatory nondiscrimination test. While an achievement award plan that meets the requirements of §410(b)(2)(A)(i) will almost certainly pass muster, it is not required.

An employee for this purpose is limited to (1) a current, common law employee or (2) a leased employee within the meaning of §414(n). Awards made by a sole proprietorship to a sole proprietor are not treated as achievement awards,[380] but where employee achievement awards are made by a partnership, the deduction limitations of §274(j)(2) apply to the partnership as well as to each member of the partnership.[381] Amounts excluded from income achievement awards, whether qualified or nonqualified, are not subject to income tax withholding, FICA or FUTA taxes.[382]

b. Employer-Operated Eating Facilities — §132(e)(2)

Under §132(e)(2), an employee may exclude from income the value of meals provided at an employer-operated eating facility for employees, provided that the annual revenue from the facility equals or exceeds the direct operating costs of the facility. But the exclusion is denied to highly compensated employees (as defined in §414(q)) unless the facility is available to a nondiscriminatory classification of employees. The determination of whether a particular classification is discriminatory depends on the facts and circumstances involved and is based upon principles similar to those applied for purposes of §410(b)(2)(A)(i).[383] Employer-operated eating facilities are de minimis fringe benefits with respect to which an employee is defined broadly to include any recipient of the benefit.[384]

Starting in 2026, although excludible by an employee, an employer cannot deduct any expense for operation of an eating facility described in §132(e)(2), and any expense for food or beverages associated with the facility.[385]

c. Qualified Employee Discounts — §132(a)(2)

Under §132(a)(2), an employee may exclude from income a price reduction on property not in excess of the gross profit percentage of the price at which the property is offered to customers, or on services of 20% of the price at which the services are offered to customers, in the ordinary course of the employer's business other than real property or discounts on personal property of a kind commonly held for investment (e.g., liquid securities).[386] Employee for this purpose is defined to include (1) a common law employee; (2) a former common law employee who retired or terminated service by reason of disability; (3) a widow or widower of an individual who died while a common law employee; (4) a widow or widower of a former employee who retired or terminated service by reason of disability; (5) a leased employee under §414(n); and (6) a partner who performs services for a partnership.[387] The exclusion is denied to highly compensated employees (as defined in §414(q)) unless the discounts are available to a nondiscriminatory classification of employees. The determination of whether a particular classification is discriminatory generally will depend upon the facts and circumstances involved, based upon principles similar to those applied for purposes of §410(b)(2)(A)(i).[388]

d. No-Additional-Cost Services — §132(b)

No-additional-cost services are those services that an employer provides to its employees but with respect to which the employer does not incur any substantial cost. Under certain circumstances, no-additional-cost services can be provided to employees of unrelated employers under a reciprocal agreement.[389] Such services must be of the kind furnished to customers of the employer in the ordinary course of its business. Generally, no-additional-cost services are services with respect to which the employer has excess capacity, such as airline, bus or train tickets; hotel rooms; or telephone services provided free or at a reduced cost to employees working in those lines of business. Employees (and their spouses and dependent children) can exclude the value of such services from income under §132(h)(2). Employee for this purpose is defined to include (1) a common law employee; (2) a former common law employee who retired[390] or terminated service by reason of disability; (3) a widow or widower of an individual who died while a common law employee; (4) a widow or widower of a former employee who

[378] §274(j)(2)(B).
[379] §74(c), §274(j)(2)(A).
[380] Prop. Reg. §1.274-8(c)(1), §1.74-2(d)(1).
[381] §274(j)(4)(A); Prop. Reg. §1.274-8(d)(1).
[382] §3121(a)(20), §3306(b)(16), §3401(a)(19).
[383] Reg. §1.132-7(a)(1)(ii), §1.132-8(d).
[384] Reg. §1.132-1(b)(4).
[385] §274(o), added by TCJA, Pub. L. No. 115-97, §13304(d)(2), and amended by the OBBBA, Pub. L. No. 119-21, §70305(a) (adding exceptions for goods sold in a bona fide transaction and for food and beverage expenses in connection with specified industries), effective for amounts paid or incurred after December 31, 2025. For further discussion of the deductibility of employer-provided meals, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses.*
[386] §132(c)(4).
[387] §132(h); Reg. §1.132-1(b)(1). *See* Rev. Proc. 2008-48 (circumstances under which IRS will treat a child of parents who are divorced, separated or living apart as the dependent of both parents for purposes of §132(h)(2)(B), among other provisions).
[388] Reg. §1.132-8(d)(1).
[389] §132(i); Reg. §1.132-2(b).
[390] *See Mihalik v. Commissioner*, T.C. Memo 2022-36 (dependent children do not include adult relatives).

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retired or terminated service by reason of disability; (5) a leased employee under §414(n); and (6) a partner who performs services for a partnership.[391] But the exclusion is denied to highly compensated employees (as defined in §414(q)) unless the service is available to a non-discriminatory classification of employees. The determination of whether a particular classification is discriminatory will generally depend upon the facts and circumstances involved, based upon principles similar to those applied for purposes of §410(b)(2)(A)(i).[392]

As is the case with most other fringe benefits that contain a nondiscrimination requirement, in determining the universe of employees that must be tested, certain employees may be excluded. They include part-time employees working less than 17-½ hours a week, seasonal employees normally working less than 6 months a year, collective bargaining unit employees if the benefit was the subject of good faith bargaining, non-resident aliens with no U.S.-source income, employees with less than one year of service, certain student employees, and employees of the leased section (e.g., a cosmetic counter or jewelry concession) of a department store.[393]

e. Qualified Tuition Reduction Programs — §117(d)

An employee of an educational organization described in §170(b)(1)(A)(ii) may exclude from income the value of any amounts received under a qualified tuition reduction program. A highly compensated employee may exclude a qualified tuition reduction from gross income, however, only if the reduction is available on substantially the same terms to each member of a group of employees included under a reasonable classification established by the employer which does not discriminate in favor of highly compensated employees.[394] The term "highly compensated employee" has the meaning provided in §414(q). Employee includes (1) a current, common law employee; (2) a former common law employee who retired or terminated service by reason of disability; (3) a widow or widower of an individual who died while a common law employee; (4) a widow or widower of a former employee who retired or terminated service by reason of disability; (5) a dependent child or spouse of any of the foregoing;[395] and (6) a leased employee under §414(n).

f. Athletic Facilities — §132(j)(4)

Under §132(j)(4), an employee may exclude from income the value of his or her use of an on-premises gym or athletic facility, but only if substantially all of the use of the facility during the year is by employees, their spouses, and their dependent children.[396] Employee for this purpose is defined to include (1) a common law employee; (2) a former common law employee who retired or terminated service by reason of disability; (3) a widow or widower of an individual who died while a common law employee; (4) a widow or widower of a former employee who retired or terminated service by reason of disability; (5) a leased employee under §414(n); and (6) a partner who performs services for a partnership.[397] Amounts excluded from income with respect to athletic facilities are not subject to income tax withholding, FICA or FUTA taxes.[398] While employer-provided gyms and on-premises athletic facilities are not subject to nondiscrimination requirements, they are subject to the deduction disallowance rules of §274(a)[399] unless excluded from such rules by the application of §274(e)(4) for recreational facilities for employees other than employees who are officers, more than 10% owners, or highly compensated employees.[400]

g. Qualified Retirement Planning Services — §132(a)(7)

Under §132(a)(7), an employee may exclude from income the value of retirement planning advice and information provided to an employee and his spouse by an employer maintaining a qualified retirement plan.[401] A highly compensated individual may only exclude amounts if the services are available on substantially the same terms to each member of a group of employees normally provided education and information regarding the employer's qualified plan.[402] For this purpose, employee is defined to include only current common law employees and leased employees within the meaning of §414(n).

9. Non-§6039D Fringe Benefits Without Nondiscrimination Standards

The last group of fringe benefit plans that are discussed below are subject to neither reporting requirements under §6039D nor separate nondiscrimination rules. Accordingly, the only tax-related concerns are those that apply to a covered worker who is not an employee. As is the case with the two previous categories, he or she cannot take advantage of the tax benefits, but may have claims for benefits, depending on the circumstances.

a. Nonqualified Achievement Awards — §74(c) and §274(j)

Under §74(c), an employee may exclude from income the value of any tangible personal property received as an award for either length of service or a safety achievement. Effective with respect to amounts paid or incurred after December 31, 2017, the term "tangible personal property," for purposes of determining a nonqualified achievement award, specifically excludes cash, cash equivalents, gift cards, gift coupons, or gift certificates (except in the case of arrangements that confer only the right to select and receive tangible personal property from a limited array of items that are pre-selected or pre-approved by the employer). It also excludes vacations, meals, lodging,

[391] §132(h); Reg. §1.132-1(b)(1) and §1.132-1(c). *See* Rev. Proc. 2008-48 (circumstances under which IRS will treat a child of parents who are divorced, separated or living apart as the dependent of both parents for purposes of §132(h)(2)(B), among other provisions).

[392] Reg. §1.132-8(d)(1).

[393] Reg. §1.132-8(b)(3), Reg. §1.132-8(d).

[394] §117(d)(3).

[395] §117(d) and §132(h); Reg. §1.132-1(b)(1). *See* Rev. Proc. 2008-48 (circumstances under which IRS will treat a child of parents who are divorced, separated or living apart as the dependent of both parents for purposes of §132(h)(2)(B), among other provisions).

[396] Reg. §1.132-1(e).

[397] Reg. §1.132-1(b)(3).

[398] §3121(a)(20), §3306(b)(16), §3401(a)(19).

[399] As amended by TCJA, Pub. L. No. 115-97, §13304(a), applicable to amounts paid or incurred after December 31, 2017.

[400] §274(e)(4), Reg. §1.274-2(f)(2)(v).

[401] §132(m)(1).

[402] §132(m)(2).

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theater or sporting event tickets, stocks, bonds, other securities, and other similar items.[403] The maximum amount that can be excluded under this provision is $400 for an award that is not a qualified plan award as defined in §274(j)(3)(B)(ii). Amounts excluded from income achievement awards, whether qualified or nonqualified, are not subject to income tax withholding, FICA or FUTA taxes.[404] But awards or gifts in excess of the allowable amount are subject to withholding, FICA and FUTA taxes.

b. De Minimis Fringe Benefits — §132(a)(4)

Under §132(a)(4), an employee may exclude from income the value of any de minimis fringe benefit. A de minimis fringe benefit is defined in §132(e)(1) to mean any property or service that has so little value (taking into account how frequently such benefits are provided to similarly situated employees) that accounting for it would be unreasonable or administratively impractical. Common examples of de minimis fringe benefits include the use of a copying machine, holiday gifts, company-sponsored parties and picnics, and tickets for entertainment and sporting events. Snacks furnished by an employer to employees on a continual basis in small, low-value, and difficult to quantify portions are also generally excludible as de minimis fringe benefits.[405] Cash is not ordinarily excludible as a de minimis fringe benefit except for occasional meal money or transportation fare. An employee for this purpose is defined broadly to include any recipient of a de minimis fringe benefit.[406] The value of meals provided to employees may be excluded from income as a de minimis fringe benefit meal under §132(a)(4). Meals must be provided (1) on an occasional basis, (2) because overtime work necessitates an extension of the employee's normal work schedule, and (3) to enable the employee to work overtime.[407]

c. Meals and Lodging Furnished for the Convenience of the Employer — §119

Under §119, an employee may exclude from income the value of meals that are furnished on the employer's business premises and for the convenience of the employer. An employee also may exclude lodging if such lodging (i) is on the business premises of the employer, (ii) is provided for the convenience of the employer, and (iii) the employee accepts such lodging as a condition of employment.[408] For purposes of this exclusion, an employee is a common law employee.

Whether such meals or lodging is for the convenience of the employer depends on all of the surrounding facts and circumstances. For instance, in TAM 201903017, the National Office advised that snacks provided in an employer's designated snack areas are not meals prepared for consumption at meal time and, therefore, are not furnished for the convenience of the employer. Accordingly, the value of those snacks are not excludible from the gross income of employees under §119.

Starting in 2026, although excludible by the employee, the employer cannot deduct any expense for meals described in §119(a).[409]

d. Moving Expense Reimbursements — §132(a)(6)

Certain active duty military who move pursuant to a military order and incident to a permanent change of station and, for taxable years beginning prior to January 1, 2018, other employees may exclude from income qualifying moving expense reimbursement under §132(a)(6), defined to mean any amount received (directly or indirectly) by an individual from an employer as a payment for (or a reimbursement of) expenses that would be deductible as moving expenses under §217 if directly paid or incurred by the individual, not including any payment for (or reimbursement of) an expense deducted by the individual in a prior taxable year.[410] For taxable years beginning after December 31, 2025, certain intelligence community members who move pursuant to a change in assignment that requires relocation also may exclude from income qualifying moving expense reimbursements.[411] An employee for this purpose is a current, common law employee or a leased employee under §414(n).[412]

e. Transportation Benefits — §132(a)(5)

The I.R.C. provides tax advantages for two categories of transportation expense: de minimis transportation expenses and qualified transportation benefits. A de minimis transportation

[403] §274(j)(3)(A)(ii), as redesignated and amended by TCJA, Pub. L. No. 115-97, §13310.

[404] §3121(a)(20), §3306(b)(16), and §3401(a)(19).

[405] In TAM 201903017, the National Office concluded that the value of the snacks is excludible from gross income as a de minimis fringe benefit under §132(e)(1) and Reg. §1.132-6, even where the same snacks do not qualify for exclusion under §132(e)(2) as meals provided in an employer-operated eating facility. For further discussion of de minimis fringe benefits, see 394 T.M., *Employee Fringe Benefits*.

[406] Reg. §1.132-1(b)(4).

[407] Reg. §1.132-6(d)(2).

[408] Reg. §1.119-1(b).

[409] §274(o), as added by TCJA, Pub. L. No. 115-97, §13304(d)(2), and amended by the OBBBA, Pub. L. No. 119-21, §70305(a) (adding exceptions for goods sold in a bona fide transaction and for food and beverage expenses in connection with specified industries), effective for amounts paid or incurred after December 31, 2025. For further discussion of the deductibility of employer-provided meals and lodging, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

[410] §132(g)(1); §132(g)(2), added by TCJA, Pub. L. No. 115-97, §11048(a)(2) (suspending exclusion for taxable years beginning after December 31, 2017, and before January 1, 2026), effective for taxable years beginning after December 31, 2017. *See* Notice 2018-75 (suspension of the exclusion applies only to payments or reimbursements for expenses incurred in connection with a move that occurred after December 31, 2017; the exclusion is available for a move made in 2017 that is paid or reimbursed in 2018). The deduction for moving expenses under §217 is also suspended for taxable years beginning after December 31, 2017. §217(k), as added by TCJA, Pub. L. No. 115-97, §11049(a) (suspending deduction for taxable years beginning after December 31, 2017, and before January 1, 2026). The employer's deduction for payment or reimbursement of an employee's moving expenses is not affected by TCJA, Pub. L. No. 115-97, §11048 or §11049.

[411] §132(g)(2), as amended by the OBBBA, Pub. L. No. 119-21, §70113(c)–(d) (making general suspension of exclusion permanent and adding intelligence community exception), effective for taxable years beginning after December 31, 2025. *See* Notice 2018-75 (suspension of the exclusion applies only to payments or reimbursements for expenses incurred in connection with a move that occurred after December 31, 2017; the exclusion is available for a move made in 2017 that is paid or reimbursed in 2018). The deduction for moving expenses under §217 is similarly suspended. §217(k), as amended by the OBBBA, Pub. L. No. 119-21, §70113(a) (making general suspension of deduction permanent and adding intelligence community exception), effective for taxable years beginning after December 31, 2025. For further discussion of moving expense deductions, see 594 T.M., *Tax Implications of Home Ownership*.

[412] §217(a), §217(f); Reg. §1.217-2(f).

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benefit is classified as any transportation benefit that has so little value (taking into account how frequently such benefits are provided to similarly situated employees) that accounting for it would be unreasonable or administratively impractical. An example of a de minimis fringe benefit might include occasional cab fare provided to an employee because the employee is working overtime. For purposes of this exclusion, any recipient of a de minimis transportation fringe benefit is treated as an employee. Qualified transportation benefits are described in §132(f) to include transportation in a commuter highway vehicle (if such transportation is in connection with travel between the employee's residence and place of employment), any transit pass, and certain parking costs. For this purpose, employee is defined to include only current common law employees and leased employees within the meaning of §414(n).[413]

The monthly limitation under §132(f)(2)(A) for transportation in a commuter highway vehicle and any transit pass is the same as the amount in effect under §132(f)(2)(B) for qualified parking.[414] The limitation is $175, as adjusted for inflation.[415]

For taxable years beginning prior to January 1, 2018, a qualified bicycle commuting reimbursement also was a qualified transportation fringe benefit for reasonable expenses incurred by the employee for the purchase of a bicycle and bicycle improvements, repair and storage, if the bicycle was regularly used for travel between the employee's residence and place of employment. The exclusion from tax was limited to $20 per month of employer reimbursements for bicycle commuting expenses.[416] For taxable years beginning after December 31, 2017, no exclusion from income is available due to the suspension of the exclusion fro any taxable year beginning after December 31, 2017, and before January 1, 2026,[417] and due to the removal of qualified bicycle commuting reimbursement as a category of qualified transportation fringe for taxable years beginning after December 31, 2025.

Although the value of employer-provided qualified transportation benefits is excludible from income taxation by an employee, an employer can neither deduct expenses for qualified transportation benefits,[418] nor any expenses incurred for providing transportation benefits to an employee, or reimbursing an employee's expenses incurred, in connection with travel between the employee's residence and place of employment, except when necessary for ensuring the safety of the employee.[419] Additionally, cash reimbursements provided for expenses incurred in the use of transit due to malfunctioning cards or systems are not qualified for transportation fringe benefits. The value of any cash reimbursements provided for such expenses is included in the employee's income and is included in wages subject to FICA, FUTA, and income tax withholding.[420] For further discussion of the deductibility of transportation expenses, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses.*

f. Working Condition Fringe Benefits — §132(a)(3)

Under §132(a)(3), an employee may exclude from income the value of property or services provided to an employee so that the employee can perform his or her job. This exclusion is referred to as a working condition fringe benefit, and it applies only to the extent that the employee could deduct the cost of the property or services as a business or depreciation expense under §162 or §167.[421] The exclusion also applies to cash payments for a specific, pre-arranged business activity so long as the employee could deduct the same had he or she paid the expense without reimbursement. Substantiation requirements apply in both cases.[422] Examples of a working condition fringe benefit might include an employee's use of a company car for a purpose related to the employer's business. Employees include (1) a current, common law employee; (2) a partner who performs services for a partnership; (3) a director of the employer; and (4) an independent contractor that performs services for the company.[423]

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[413] Reg. §1.132-9(b), Q&A-5.

[414] §132(f)(2)(A), as amended by the Protecting Americans From Tax Hikes Act of 2015, Pub. L. No. 114-113, Div. Q, §105, as further amended by TCJA, Pub. L. No. 115-97, §11002(d)(5), effective for taxable years beginning after December 31, 2017. Effective retroactively for months after December 31, 2014, Pub. L. No. 114-113, Div. Q, §105 permanently amended §132(f)(2)(A) so that the maximum amount of qualified parking, and the aggregate of employer-provided transit passes and transportation in a commuter highway vehicle, excludible from an employee's gross income are the same.

[415] For the current and prior years' amounts, see Worksheet 10 of 394 T.M., *Employee Fringe Benefits.*

[416] §132(f)(1)(D), added by Pub. L. No. 110-343, Div. B, §211, effective for taxable years beginning after December 31, 2008, and §132(f)(1)(D), struck by OBBBA, Pub. L. No. 119-21, §70112(a)(1), effective for taxable years beginning after December 31, 2025, §132(f)(2)(C), and §132(f)(5)(F), struck by OBBBA, Pub. L. No. 119-21, §70112(a)(2) and §70112(a)(4), effective for taxable years beginning after December 31, 2025; §132(f)(4), as amended by OBBBA, Pub. L. No. 119-21, §70112(a)(3).

[417] §132(f)(8), added by TCJA, Pub. L. No. 115-97, §11047(a), struck by OBBBA, Pub. L. No. 119-21, §70112(a)(5), effective for taxable years beginning after December 31, 2025.

[418] §274(a)(4), added by TCJA, Pub. L. No. 115-97, §13304(c)(1)(B), applicable to amounts paid or incurred after December 31, 2017.

[419] §274(l), added by TCJA, Pub. L. No. 115-97, §13304(c)(2), applicable to amounts paid or incurred after December 31, 2017, except in the case of any qualified bicycle commuting reimbursement for any amount paid or incurred after December 31, 2017, and before January 1, 2026, and amended by OBBBA, Pub. L. No. 119-21, §70112(c), effective for taxable years beginning after December 31, 2025.

[420] CCA 201949019.

[421] §132(d).

[422] Reg. §1.132-5(a)(1)(ii). *See* §274(d), as amended by TCJA, Pub. L. No. 115-97, §13304(a)(2)(A); Reg. §1.274-5.

[423] Reg. §1.132-1(b)(2).

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IV. Special Plan Coverage Issues and Problems

Much of the discussion over worker classification centers on the size and scope of the contingent workforce and the manner in which it might be regulated. There are, however, a host of real world problems that are increasingly occupying the attention of employers and plan sponsors and their advisors. The rapid growth of staffing firms and PEOs presents new challenges to employers and requires them to master a new vocabulary. Prior to *Microsoft*, the cases involving employee benefit plans and employee leasing arrangements were largely confined to small closely held companies and professional practices seeking to cover owners while excluding rank-and-file employees. The *Microsoft* case moved contingent worker issues to center stage for companies of all sizes. The plaintiff's bar and the regulators, among others, have taken notice of this development. While it should be possible to exclude leased employees from plan participation, to do so requires an understanding of the common law status of such workers. These workers may or may not be common law employees depending on the surrounding facts and circumstances. Meticulous attention must be paid to plan design, drafting, and implementation. It also helps to have an understanding of how the jurisprudence in this area of the law has evolved. These problems are further complicated when the employer or plan sponsor is a joint venture or a limited liability company, which introduces additional levels of uncertainty and complexity.

A. Leased Employees

Where worker classification is concerned, the term "leased employee" suffers from an acute, and in some instances fatal, case of schizophrenia. The manner in which that term is defined in the I.R.C., which is remedial in nature, can and often does mean something entirely different when used in popular or industry parlance, where it is generally understood to mean any employee who is hired through a leasing agency, staffing firm, or PEO. Section 414(n) leased employees are by definition not common law employees of the recipient employer/plan sponsor. Common law employees are already protected under Title I of ERISA and generally must be counted for purposes of applying the I.R.C.'s nondiscrimination rules. The leased employee who is not a common law employee is the subject of §414(n). Employees leased through leasing firms, staffing agencies and even PEOs often are common law employees of the service recipient depending on the application of the *Darden* test, irrespective of the parties' intentions.

1. Terminology

For purposes of this discussion, the phrase "statutory leased employee" is used to designate a leased employee as defined in §414(n).

2. Antecedents of the Leased Employee Rules — The Kiddie and Garland Cases

In *Thomas Kiddie, M.D., Inc. v. Commissioner*,[424] the question before the Tax Court was the extent to which employees of related entities might be excluded from participation in a tax-qualified retirement plan without adversely affecting the plan's favorable tax status. Dr. Kiddie was the sole shareholder, sole director, president, and treasurer of his professional corporation. Kiddie hired Dr. Smith as a clinical pathologist in 1969, and Smith thereafter established his own professional corporation. Later, the two physicians joined forces and established a partnership. Each professional corporation owned a 50% interest in the partnership. Kiddie also entered into a contract with a local hospital to establish a pathological laboratory, pursuant to which he hired a staff of four individuals. The contract was assigned later to the partnership. Kiddie's professional corporation had a pension plan that covered him alone. On audit, the IRS determined that, although nominally employed by the pathology laboratory, the employees of Kiddie's professional corporation had been improperly excluded from the pension plan. This resulted in the pension plan's disqualification. The IRS also disallowed a deduction for plan contributions for those years.

The court applied a multi-factor test and concluded that the employees were employees of Kiddie's professional corporation and not independent contractors. Kiddie's right to control their actions was an important factor in reaching this result. As a consequence, these individuals were eligible employees for pension plan purposes. But the court disagreed with the IRS with respect to the period following the transfer of the hospital contract to the partnership, and it rejected the IRS's argument that employees of the partnership were employees of Kiddie's professional corporation for §401 purposes. Looking to the I.R.C. provisions that govern the taxation of partnerships, the court held that, because the professional corporation did not have control (it owned 50% of the partnership), it would not attribute the partnership's employees to the professional corporation. It then looked to the terms of the plan and determined that the employees were not employees of the professional corporation on the date on which they would have satisfied the pension plan's eligibility requirements.

In *Garland v. Commissioner*,[425] the Tax Court faced issues similar to those presented by *Kiddie*. Dr. Garland was the sole employee of a professional association. Prior to the formation of the professional association, Garland had practiced medicine in partnership with Dr. Dunn, Jr. That partnership was eventually dissolved, and Garland's professional association and Dunn entered into a partnership in which each partner owned a 50% interest in profits. Garland's professional association adopted a pension plan to which it made contributions on behalf of Garland and the employees of the partnership. Following the enactment of ERISA, the plan was amended to exclude the partnership's employees. The professional association then submitted the plan, as amended, to the IRS for a favorable determination letter. The request was denied for failure to cover employees of the partnership.

The Tax Court determined that the controlled group rules of §414(c) did not apply. Looking to §414(b) and §1563(a), the court determined that, for a controlled group to exist, affiliated entities must be a parent-subsidiary group, a brother-sister group, or a combined group. The court determined that the professional association and the partnership fit none of these cri-

[424] 69 T.C. 1055, 1057, 1 EBC 1610 (1978).

[425] 73 T.C. 5, 1 EBC 1614 (1979).

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teria. The inquiry then narrowed to whether the partnership's employees must be considered employees of the professional association for the purposes of §401(a)(4) and §410(b)(1).

The IRS attempted to preserve the controlled group argument by claiming that §414(c) was not intended to be the exclusive test for determining whether the employees of affiliated entities should be aggregated for §401 purposes, and it asked the court to overrule *Kiddie*. Specifically, the IRS wanted the court to hold that the employment relationship between the partnership and its employees must be attributed to each partner notwithstanding the possibility that his interest in partnership profits or capital may not exceed 50%. In declining this invitation, the court observed:

> On brief respondent [the Commissioner of the IRS] repeatedly makes the assertion that section 414(c) was not intended to be the exclusive test for employee attribution where affiliated entities are involved. Yet he is unable to advance a single cogent argument in support of that claim. The mere fact that the statute does not explicitly state that it is the exclusive test does not necessarily imply that the reverse is true. We think sections 414(b) and 414(c) were intended to provide a definitive answer to the question of whether the employees of related entities should be aggregated for purposes of evaluating plan discrimination. …
>
> It is apparent from the committee report that Congress was aware that prior to the enactment of ERISA it was possible to circumvent the antidiscrimination provisions through the use of related business entities. To safeguard against this possibility Congress enacted legislation which establishes a straightforward, objective test for determining whether the employees of affiliated entities should be treated as employed by a single employer. Under this test the employees will be so treated if the business entities are found to be under common control as defined in regulations based on controlled group principles. In light of this direct congressional response to the employee attribution problem and the express statement of intent to clarify this matter for the future … we see no reason to fortify the provisions of section 414(c) with other, more stringent tests such as the one respondent has proposed in the present case. Accordingly, we hold that sections 414(b) and 414(c) are the exclusive means for determining whether employees of related trades or businesses should be aggregated for purposes of applying the antidiscrimination provisions.[426]

The Tax Court embraced *Kiddie* and held that, for purposes of §401, the employment relationship between the partnership and the employee was not to be attributed to the professional association in this instance because the requisite levels of ownership were absent. Therefore, the court ruled that the plan qualifies under §401(a).

[426] *Garland*, 73 T.C. at 16–17. *See* H. Rep. No. 93-807, 1974-3 (Supplement) C.B. 285.

a. The Evolution of §414(n)

The *Kiddie* and *Garland* cases exposed a flaw in the I.R.C.'s controlled group provisions, i.e., §414(b) and §414(c), that were enacted as a part of ERISA. While they were intended to prevent the use of multiple entities to evade the nondiscrimination rules, they were not sufficiently broad to cover instances where certain entities were as a practical matter tightly intertwined but technically lacked control. Congress responded to these and other cases by enacting the affiliated service group, leased employee, and related rules of §414(m), §414(n), and §414(o). Both *Kiddie* and *Garland* would almost certainly have been decided differently under the affiliated service group rules of §414(m).[427] In the context of worker classification, however, the focus has been principally on the leased employee provisions of §414(n).

Section 248(a) of the Tax Equity and Fiscal Responsibility Act of 1982[428] added §414(n) relating to employee leasing arrangements. As originally adopted, a leased employee was defined to mean a person who provided services to a recipient organization: (1) pursuant to an agreement between the recipient and the leasing organization;[429] (2) on a substantially full-time basis for at least one year (including services provided to related persons of the recipient); and (3) of a type historically performed, in the business of the recipient, by employees. Contributions or benefits provided to leased employees under a qualified plan or SEP maintained by the leasing organization were treated as having been made by the recipient to the extent of service performed on the recipient's behalf, and the employee leasing rules did not apply where the leased employees were covered under a non-integrated money purchase plan with an allocation rate of at least 7.5% of compensation.

Congress made a technical correction to the definition of leased employee in §526(b) and §713(i) of the Deficit Reduction Act of 1984[430] under which a common law employee of a recipient company could not also be the recipient's leased employee. This change was intended to prevent professionals from being hired and leased back to their professional corporation by a leasing company that sponsors a safe harbor plan in order to avoid applicable nondiscrimination rules. Section 1146 of the TRA '86 made a number of further modifications. For example, the allocation rate for the safe harbor money purchase plan was increased from 7.5% to 10%; leased employees were treated as employees of the recipient irrespective of the existence of a safe-harbor plan if more than 20% of the recipient's non-highly compensated workforce consisted of leased employees; and the employee leasing provisions were expanded to include a host of other non-pension benefits. In April 1988, the IRS issued a set of proposed regulations that included guidance under §414(n), but the bulk of those regulations were later withdrawn.[431] As a result of widespread dissatisfaction particularly

[427] *See* Rev. Rul. 81-105. For a discussion of the affiliated service group rules under §414(m), see 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*.

[428] Pub. L. No. 97-248.

[429] *See* Notice 84-11, Q&A-6 (agreement could be written or oral).

[430] Pub. L. No. 98-369.

[431] Former Prop. Reg. §1.414(m)-5, §1.414(m)-6, §1.414(n)-1, §1.414(n)-2, §1.414(n)-3, §1.414(n)-4 and parts of §1.414(o)-1 were withdrawn by the Treasury. 58 Fed. Reg. 25,587 (Apr. 27, 1993).

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with the historically performed prong of the leased employee test, Congress replaced that test in the SBJPA with a test that seeks to identify the person or entity that had primary direction and control over the worker.

b. Current §414(n)

Section 414(n)(2) defines the term "leased employee" as:

> [A]ny person *who is not an employee of the recipient* and who provides services to the recipient if — (A) such services are provided pursuant to an agreement between the recipient and any other person (in this subsection referred to as the "leasing organization"), (B) 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 1 year, and (C) such services are performed under primary direction or control by the recipient. (Emphasis added.)

The rules governing the treatment of leased employees have never required that a recipient employer cover leased employees (within the meaning of §414(n)) under the recipient's tax-qualified pension, profit-sharing, and stock bonus plans or any of its fringe benefit plans; rather, these rules require only that leased employees be counted when conducting the nondiscrimination testing that applies to such plans. Unless an exception applies (such as coverage under a safe harbor plan), §414 leased employees must be taken into account when applying the following provisions of the I.R.C.:[432]

- §79, Group-Term Life Insurance Purchased for Employees;
- §106, Contributions by Employer to Accident and Health Plans;
- §117(d), Qualified Tuition Reduction;
- §125, Cafeteria Plans;
- §127, Educational Assistance Programs;
- §129, Dependent Care Assistance Programs;
- §132, Certain Fringe Benefits;
- §137, Adoption Assistance Programs;
- §274(j), Employee Achievement Awards;
- §401(a)(3) (cross-reference to §410 minimum participation requirements);
- §401(a)(4) (general nondiscrimination standard);
- §401(a)(7) (cross-reference to §411 vesting requirements);
- §401(a)(16) (cross-reference to §415 contribution limits);
- §401(a)(17) (includible compensation limits);
- §401(a)(26) (special nondiscrimination rule for defined benefit plans);
- §408(k), Simplified Employee Pension Defined;
- §408(p), Simple Retirement Accounts;
- §410, Minimum Participation Standards;
- §411, Minimum Vesting Standards;
- §415, Limitations on Benefits and Contributions Under Qualified Plans;
- §416, Special Rules for Top-Heavy Plans;
- §505, Additional Requirements for Organizations Described in Paragraph (9) or (17) of Section 501(c); and
- §4980B, Failure to Satisfy Continuation Coverage Requirements of Group Health Plans.

Comment: Missing from this list is any reference to §105(h), which governs discriminatory self-insured medical expense reimbursement plans. Accordingly, service as a leased employee under §414(n) need not be counted if the employee is later hired by the recipient of the leased employee's services for purposes of determining eligibility under the recipient's self-insured medical reimbursement plan.

According to the report issued by the Conference Committee in connection with SBJPA (the Conference Committee Report),[433] the fact that a person is or is not found to perform services under the primary direction and control of the recipient for purposes of the employee leasing rules is not determinative of whether the person is or is not a common law employee of the recipient.[434] Using the Conference Committee Report approach, the primary direction and control prong of the leased employee test is applied only after it has been determined that the worker is the common law employee of the leasing organization and not the recipient. Thus, an individual who is not a common law employee of the service recipient can nevertheless be the service recipient's leased employee.

The tests applied at each step are not identical — nor could they be for the distinction proffered by the Conference Committee Report to have any viability. According to the Conference Committee Report, factors that are relevant in determining whether primary direction or control exists include whether (1) the individual is required to comply with instructions of the service recipient about when, where, and how he or she is to perform the services, (2) the services must be performed by a particular person, (3) the individual is subject to the supervision of the service recipient, and (4) the individual must perform services in the order or sequence set by the service recipient.

The following factors are irrelevant to the inquiry: whether the service recipient has the right to hire or fire the individual and whether the individual works for others. With the right to discharge left out of the equation, actual day-to-day supervision exercised by the service recipient is apparently deemed sufficient to establish that the worker is under the primary direction and control of the service recipient while the unexercised control of the leasing organization establishes it as the common law employer.

The Conference Committee Report explains its view as follows:

[432] §414(n)(3), as amended by Pub. L. No. 113-295, Div. A, §221(a)(19) (removing former §120 regarding amounts received under qualified group legal services plans from the I.R.C.), effective December 19, 2014.

[433] H.R. Rep. No. 737, 104th Cong., 2d Sess. 94, 258 (1996).

[434] H.R. Rep. No. 737, at 259.

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> [A]n individual who works under the direct supervision of the service recipient would be considered to be subject to primary direction or control of the service recipient even if another company hired and trained the individual, had the ultimate (but unexercised) legal right to control the individual, paid his wages, withheld his employment and income taxes, and had the exclusive right to fire him. Thus, for example, temporary secretaries, receptionists, word processing personnel and similar office personnel who are subject to the day-to-day control of the employer in essentially the same manner as a common law employee are treated as leased employees if the period of service threshold is reached. On the other hand, an individual who is a common law employee of Company A who performs services for Company B on the business premises of Company B under the supervision of Company A would generally not be considered to be under primary direction or control of Company B. The supervision by Company A must be more than nominal, however, and not merely a mechanism to avoid the literal language of the direction or control test.[435]

Analytically, this is a difficult proposition. The common law test for employee status does not lend itself to such a bifurcated approach. If a service recipient integrates leased employees into its regular workforce, then the level of day-to-day direction and control that it exercises over the leased employees should be indistinguishable from the level of direction and control that it exercises over its regular workforce. How is it then that an individual is a common law employee in one instance and not in another, where the law purports to apply the same multi-factor test in each case? One possible answer is that the scope of the leased employee rule is more limited than it might first appear, and that it clearly does not encompass all workers retained through leasing companies, staffing firms, or PEOs. Rather, leased employee status occurs only in those instances where the leasing company involvement is substantial. An example of how such an arrangement might work is illustrated in Rev. Rul. 75-41, which is described below. In all other cases, the worker is most likely the common law employee of the recipient irrespective of the intervening leasing agreement.

c. Revenue Ruling 75-41

Although it pre-dates §414(n), Rev. Rul. 75-41 describes a set of circumstances wherein a recipient employer may well have primary direction and control but is not the common law employer. A staffing company provided to professional firms ("subscribers") the services of secretaries, nurses, dental hygienists, and other similarly trained personnel. The staffing company entered into contracts with the subscribers, which specified the services to be provided and the fees to be paid. Under the contracts, subscribers had the right to require that an individual furnished by the corporation cease providing services to them and be replaced by the staffing company within a reasonable period of time. The subscribers had no right to affect the contract between the worker and the staffing company. The contracts also provided that the staffing company had the right to remove or reassign any personnel furnished to subscribers in which case it had to either furnish a replacement promptly or adjust the fee accordingly.

The workers were recruited by the staffing company and given various tests to determine their qualifications and degree of skill. The staffing company hired the workers, paid their wages, and provided them with liability and unemployment insurance, workers' compensation, and other benefits. Under the contract with the staffing company, the workers agreed to be available to perform services for any subscribers to which they were assigned. The contract set forth the amounts to be paid to the workers, and the fee that the staffing company charged to the subscribers was based on a predetermined mark-up formula. The staffing company had the contractual right to evaluate the performance of the workers and to discharge them for substandard performance if applicable. Workers who entered into contracts with the staffing company agreed that they would not contract directly with any subscriber to which they were assigned for at least three months after their contract with the staffing company ended. The staffing company directed the worker as to his or her hours and the nature of his or her duties, based on the subscriber's request. Subscribers relied on the staffing company to see to it that the individual met the qualifications they required.

The IRS began by noting that an employer-employee relationship generally exists when (1) the person for whom the services are performed has the right to control and direct the individual who performs the services, as to the result to be accomplished by the work and as to the details and means by which the result is to be accomplished, and (2) 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. It is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient that he has the right to do so. Also, the right to discharge is an important factor indicating that the person possessing that right is an employer. Under the facts presented, the IRS ruled that that the leasing company was the employer of the individuals for tax purposes.

Under the approach envisioned by the Conference Committee Report, the first step in the inquiry is to determine whether the worker was an employee of the staffing company in a manner similar to that described in Rev. Rul. 75-41. If the worker is not the employee of the recipient, then the next step is to determine whether the worker is under the primary direction and control of the recipient. This is an intensely factual inquiry to be sure, but if the worker is found to be under the primary direction and control of the recipient and the other threshold requirements are met (i.e., the services are pursuant to an agreement and they have been furnished on a substantially full-time basis for more than a year), then the worker is a leased employee under §414(n). He or she will then need to be counted for discrimination testing purposes unless some other exception applies (e.g., he or she might be covered under a safe harbor plan).

d. Leased/Worksite Employees vs. §414(n) Leased Employees

The distinction between leased employees under §414(n) and employees retained through leasing companies, staffing

[435] H.R. Rep. No. 737, at 259.

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firms, or PEOs highlights a potential trap for the unwary. If a plan covers all employees of a recipient employer but excludes leased employees as defined in §414(n), and, if based on the surrounding facts and circumstances the leased worker is actually the common law employee of the recipient (which is often the case), then the plan provision will not work as intended, and the leased employees will be eligible to participate. If the plan defines leased employees without reference to the I.R.C., however, then the leased employees will be properly excluded. This distinction is expanded upon in the two cases discussed below.

(1) Burrey v. Pacific Gas and Electric Co.

In *Burrey v. Pacific Gas and Electric Co.*,[436] Burrey and others brought suit under ERISA against Pacific Gas & Electric Co. (PG&E), several of the PG&E employee benefit plans, and the plans' administrative committee. The plaintiffs worked at various times at PG&E's marketing center. In 1983, PG&E transferred all of the employees working at the marketing center, including the plaintiffs. After being told that they would continue to work at the marketing center as employees of an employment agency, the plaintiffs consented to the transfer. Although the plaintiffs were trained by the employment agency, they worked alongside PG&E employees, and used PG&E's computer system, telephones and e-mail. PG&E sent its employees, including plaintiffs, to classes and seminars regarding debt collection, customer service, and general office skills. Plaintiffs were also required to attend PG&E's sexual harassment and emergency response programs. PG&E gave the plaintiffs PG&E business cards and letterhead and occasional use of company cars. Plaintiffs' work-related expenses, including travel expenses, were reimbursed by PG&E. Both PG&E and the employment agency provided supervisors to oversee the day-to-day operations of the marketing center. The plaintiffs' wages were paid by the employment agency. Later, PG&E and its employment agency entered into a new and substantially different contract under which PG&E transferred the primary authority for the daily control over the marketing center to the employment agency. Thereafter, PG&E stopped allowing marketing center employees to use PG&E business cards and letterhead; ceased providing training classes for marketing center employees; discontinued reimbursing work-related expenses; and halted altogether providing company cars to these employees.

PG&E provided several employee benefit plans to its employees, including a retirement plan, savings plan, health plan, and severance plan. Under the terms of the retirement plan and savings plan, benefits are not available to "leased employees, as defined by §414(n)." PG&E's health and severance plans did not expressly exclude leased employees from coverage. Under the health plan, an employee was automatically enrolled on the first day of work in a medical plan without dependent coverage. Under the severance plan, however, a terminated employee was entitled to severance benefits upon satisfying certain requirements, such as the completion of severance pay forms.

The Ninth Circuit held that the district court erroneously concluded that the plaintiffs were leased employees under §414(n). The Ninth Circuit remanded the case to the district court with instructions to determine whether the plaintiffs were common law employees. In so holding, it made clear that the "primary direction and control" element of §414(n) was only one factor of many to be considered in assessing common law employee status. The court's precise holding is instructive:

> We hold that "employee" as used in §414(n) means "common law employee" and an individual's employment status under §414(n) should be determined using the twenty-factor test adopted in *Darden*. We do not address here whether the plaintiffs could qualify as common law employees. Instead, we merely conclude that the district court erred by not considering whether the plaintiffs qualified as common law employees as a threshold determination of whether the plaintiffs were leased employees under §414(n). We therefore reverse the district court's order and remand this issue in order that the district court may make a determination of the plaintiffs' employment status under §414(n).[437]

On remand, the district court ruled in an unpublished order in favor of PG&E based on its view that the §414(n) definition of leased employee as constituted after the SBJPA is internally inconsistent because a common law employee is, by definition, subject to the primary direction and control of the employer/plan sponsor, but a leased employee under §414(n) cannot be a common law employee of the employer/plan sponsor.[438] This argument generally equates the primary direction and control requirement of §414(n) with the multi-factor tests used by the IRS to ascertain employee status. As noted in IV.A.2.b., the Conference Report expressly rejected this argument.

(2) Wolf v. Coca Cola Company

Wolf worked as a computer programmer and analyst at the Coca-Cola Company. She was at all times employed through a staffing company independent of Coca-Cola under a series of single-year agreements that described her as an independent contractor. Following her termination, Wolf filed suit against Coca-Cola under ERISA claiming that she was an employee and, as such, entitled to benefits under Coca-Cola's employee benefit plans. The district court granted Coca-Cola's motion for summary judgment on the ERISA claims.

The Court of Appeals applied a two-pronged test.[439] First, it inquired whether Wolf was a common law employee under the *Darden* test, and second whether she was eligible for benefits under the terms of the plans. The court conceded that Wolf might well have a legitimate argument that she was a common law employee of Coca-Cola. Her claim failed, however, because the terms of the plan specifically excluded from participation individuals who perform services for the Company under an agreement with a leasing organization. Citing *Abraham v. Exxon Corp.*, the court held that plan sponsors are not required by ERISA to make their ERISA plans available to all common law employees.[440] It then distinguished cases such as

[436] 159 F.3d 388, 22 EBC 1887 (9th Cir. 1998).

[437] 159 F.3d at 394.

[438] No. C-95-4638 DLJ (N.D. Cal. May 12, 1999) (unpub. op.).

[439] 200 F.3d 1337, 23 EBC 2497 (11th Cir. 2000).

[440] *Accord*, *Curry v. CTB McGraw-Hill, LLC*, 37 EBC 2390 (unpub. op.) (N.D. Cal. 2006) (holding that a benefit plan may lawfully exclude "leased employees" using definition broader than that contained in §414(n)); *Moxley*

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Burrey v. Pacific Gas Co. wherein the term leased employees was defined with reference to §414(n), which defines a leased employee as a person who is not a common law employee and who meets certain other criteria.

e. Plan Drafting Issues

Armed with an appreciation of the difference between the manner in which the term leased employee is defined in §414(n) and the manner in which that term is used in industry parlance, the drafting (and testing) issues become much simpler. While leased employees of either variety need not be covered under a plan, both need to be included in the plan's nondiscrimination testing. A plan can, as a result, include or exclude these individuals from plan participation to the extent permitted by the applicable nondiscrimination rules. However, the IRS does require plans covered by §414(n)(3) to specifically address how §414(n) leased employees are treated.[441] But, generally, if a plan sponsor wants to exclude employees retained through a staffing company from plan participation, then it must do so explicitly and without referring to §414(n).

3. Time-Out Clauses

One of the legacies of *Microsoft* is the adoption of time-out requirements in employee staffing programs. Under a typical time-out provision, a worker might be required to take a six-month hiatus after working for the employer for a year. These provisions are intended, at least in part, to avoid turning temporary workers into perma-temps — i.e., workers who are purportedly hired for short-term job tenures but end up working indefinitely at jobs that are indistinguishable from regular, full-time employment. Some employers look to time-out clauses to provide a bright-line test that will allow them to avoid worker misclassification issues. This view is mistaken. The length of the employment relationship is only one of many factors that are considered when determining a worker's status. Time-out clauses do serve to minimize contacts with the employer, and in a close case it is possible that a time-out clause might tip the scales away from employee status. Where the goal is to exclude workers retained through staffing companies, the better approach is to adopt a custom-tailored plan provision that excludes these individuals. *See* III.B.5.

B. Professional Employer Organizations (PEOs)

The emergence of the PEO responds to the ever-increasing complexity of the laws governing the workforce by allowing employers — small employers in particular — to outsource their tax and benefits compliance to specialists with expertise in these areas. Employers often view this expertise as too difficult or costly to handle in-house. PEOs also allow small employers to band together to purchase their employee benefit programs collectively, thereby reducing costs and, according to industry sources, expanding access to coverage.[442] But paradoxically, workers retained though PEOs are not part of even the broad definition of the contingent workforce adopted in the DOL Advisory Council Study. These workers are often indistinguishable from traditional employees except that certain compliance and benefit functions have been unbundled in a manner that is, for the most part, transparent to the worker. The problem is that our current regulatory structures are unable to accommodate this unbundling.

PEOs are reported to be the fastest growing segment of the contingent workforce.[443] Industry estimates place the number of workers covered under PEO arrangements at 2 to 3 million Americans, and the rate of growth is estimated to be from 20% to 30% annually.[444] Industry sources describe the average PEO client customer as having 19 worksite employees.[445] PEOs act as intermediaries between employers and their workforces. They usually target smaller employers, and they contractually assume and perform some or all of the following tasks:

- They manage their client's human resource functions by providing expertise in such disciplines as risk management, regulatory compliance and payroll processing and accounting.
- They routinely handle compliance with EEOC and NLRA and Title VII requirements, as well as FLSA, COBRA,[446] ADA, FMLA and immigration laws, among others.
- They are almost universally responsible for paying employee wages and handling the associated tax withholding, filing and reporting.
- They provide employees with workers' compensation, federal and state unemployment insurance and statutory disability coverage.
- They typically make available a broad range of employee and fringe benefits including health insurance, dental and vision care, group-term life insurance, retirement savings, job counseling, adoption assistance, and educational benefits.

The recipient company retains primary responsibility for managing employee tasks such as daily work assignments and

v. Texaco, Inc., 2001 U.S. Dist. LEXIS 3930 (C.D. Cal. 2001) (holding plan language that clearly excluded employees who provide services under leasing agreement was enforceable and did not violate ERISA).

[441] Notice 84-11, Q&A-16 (relating to the treatment of leased employees). The notice provides: "How leased employees will be treated under a recipient's plan depends on the terms of the plan. Therefore, if an organization utilizes the services of leased employees, the plan must specifically provide how leased will be treated under the recipient's plan." Notice 84-11, Q&A-16.

[442] *See* DOL Advisory Council Study, Testimony of Milan Yager, Executive Vice President, National Association of Professional Employer Organizations, p. 20 (citing the results of a study commissioned by his organization's member firms showing that, prior to establishing the PEO relationship, only 4% of the client firms surveyed offered §401(k) savings plans, and that after establishing the relationships 90% of covered employees had access to §401(k) plans).

[443] There is some disagreement over whether employees furnished through PEOs qualify as contingent workers. Although such employees were not included within the contingent workforce for purposes of the Advisory Council Report, that report acknowledged that "from the employee's standpoint, they have all the hallmarks of the disconnect between employer and employee that characterize the other cohorts of the contingent workforce." Advisory Council Report, p. 5.

[444] National Association of Professional Employer Organizations, PEO Industry Information: Frequently Asked Questions, http://www.napeo.org/what-is-a-peo/selecting-a-peo/faqs.

[445] National Association of Professional Employer Organizations, PEO Industry Information: Frequently Asked Questions, http://www.napeo.org/what-is-a-peo/selecting-a-peo/faqs.

[446] Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272.

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on-site supervision; ensuring production or service delivery; and furnishing tools, materials and equipment to the workers.

The principal impediment to the widespread adoption of the PEO model has been regulatory. Prior to 2016, there was a gulf between the traditional concepts of employment-based benefits and the PEO model under which benefits were provided at the level of the PEO. Coverage under employee benefits plans, and the salutary tax benefits accorded to participants in fringe benefit plans, are generally limited to employees of the plan sponsor and those entities within the same controlled group of entities that include the plan sponsor. Therefore, before 2016, PEOs could cover workers placed with client companies only if there is an employment or controlled group relationship. A PEO would rarely be in the same controlled group as the recipient, and when one applies the *Darden* factors, most workers placed by PEOs will be common law employees of the recipient and not the PEO. This placed the PEO in the horns of a dilemma: If it failed to offer employee benefits, then some of its competitive luster would be lost, but if it did offer employee benefit programs the PEO was likely to run afoul of the law. PEOs that offer comprehensive PEO-level employee benefit programs attempted to bridge this gap either by advancing the claim that the workers are co-employees of the PEO and the client company, or by establishing their various employee benefits plans as multiple employer plans.

Effective January 1, 2016, the I.R.C. defines a new type of employer, the certified PEO.[447] A certified PEO (CPEO) is treated as the employer of client employees for federal employment tax purposes with respect to the remuneration paid by the certified PEO to the worker and is solely liable for payroll taxes and penalties. The CPEO has this responsibility without regard to receipt or adequacy of payment from the client. The CPEO is treated as the successor employer for purposes of §3121(a)(1), §3231(e)(2)(C), and §3306(b)(1) (generally defining wages for employment tax purposes) and its unrelated customer is treated as the predecessor employer during the term of a service contract.[448] The client is still the employer for all other purposes, including benefit plans and ERISA. Reg. §301.7705-2[449] provides the requirements procedure for PEOs seeking to become certified by the IRS. Certification requirements include (1) certain reporting obligations, (2) posting a bond, (3) computing taxable income using an accrual method of accounting, and (4) submitting audited financial statements.[450] Effective December 29, 2016, the IRS issued Rev. Proc. 2017-14, which consolidated all guidance on CPEOs issued before final regulations. Generally, the guidance in Rev. Proc. 2017-14 was incorporated into the final regulations. The IRS, however, indicated that it would update the guidance periodically to provide intermittent enhancements to the CPEO program.[451]

Not all PEOs will be certified under this voluntary program. For further discussion of the CPEO program, see 392 T.M., *Withholding, Social Security, and Unemployment Taxes on Compensation.*

Before 2012, the DOL had not addressed whether plans sponsored by a PEO qualify as employee pension benefit plans under ERISA §3(2). In DOL Adv. Op. 2012-04A, the DOL concluded that a §401(k) plan maintained for employees of unrelated employers, as well as employees of a limited-purpose corporation that was designed to operate the plan, was not a multiple employer plan (MEP) but rather is an arrangement under which each participating employer established and maintained a separate employee benefit plan for the benefit of its own employees. Although the certified PEO program eliminated the uncertainty with regard to employment taxes for those PEOs becoming certified and Rev. Proc. 2002-21 addresses tax qualification issues, uncertainty existed for ERISA and benefit plan purposes.

In 2018, an executive order titled "Strengthening Retirement Security in America" directed the DOL Secretary to examine policies that would: (1) clarify and expand the circumstances under which U.S. employers, particularly small and mid-sized businesses, may sponsor or adopt a multiple employer plan as a workplace retirement savings option for their employees; and (2) expand the access of part-time workers, sole proprietors, working owners, and other entrepreneurial workers with nontraditional employer-employee relationships to workplace retirement savings plans, including MEPs.[452] The DOL issued a rule intended to clarify the circumstances under which a PEO or an employer group or association may sponsor a workplace retirement plan that constitutes a multiple employer retirement plan (or an association retirement plan). The rule, which applies as of September 30, 2019, supersedes preexisting DOL subregulatory interpretive rulings under ERISA §3(5) pertaining to bona fide groups or associations of employers sponsoring a multiple employer plan that is a defined contribution retirement benefit plan.[453] For discussion of this rule, see IV.B.9., below.

1. The Common Law Doctrine of Co-Employment

The Restatement (Second) of Agency (the Restatement) posits three species of worker that can have more than one employer.[454] A worker may be a sub-servant; the worker may simultaneously work for two parties; or the worker can be borrowed from one employer and lent to another. Restatement §5(2) defines a sub-servant to be a person appointed by a servant empowered to do so, to perform functions undertaken by the servant for the master and subject to the control as to his physical conduct both by the master and by the servant, but for whose conduct the servant agrees with the principal to be primarily responsible. The essential feature of the sub-servant relationship is that the sub-servant is subject to the direction and

[447] *See* §3511 and §7705, added by the Stephen Beck, Jr., Achieving a Better Life Experience Act of 2014, Pub. L. No. 113-295, Div. B, §206(b), effective for wages for services performed on or after January 1 2016.

[448] §3511(b).

[449] Added by T.D. 9860, 84 Fed. Reg. 24,367 (May 28, 2019), effective May 28, 2019, and applicable on or after May 3, 2019.

[450] §7705(b), §7705(c); Reg. §301.7705-2.

[451] T.D. 9860, 84 Fed. Reg. 24,367 (May 28, 2019) (preamble). *See also* Rev. Proc. 2023-18, *modifying and superseding* Rev. Proc. 2017-14 and Rev. Proc. 2016-33.

[452] Executive Order 13847, 83 Fed. Reg. 45,321 (Sept. 6, 2018).

[453] RIN 1210-AB88, 84 Fed. Reg. 37,508 (July 31, 2019).

[454] Restatement (Second) of Agency (1958) (describing and summarizing the common law governing the relationship between master and servant on which notions of employment are based in large part). For purposes of this, discussion, "employer" and "employee" are substituted for or used interchangeably with the words "master" and "servant," respectively.

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control of a servant who is, in turn, subject to the direction and control of the master. In the PEO setting, service recipient has direction and control of the worker, but not of the PEO. Establishing that a worker is a sub-servant would require that the recipient of the worker's services was the servant of the PEO. This is highly unlikely.

Simultaneous employment is described in Restatement §226 in the following terms: "A person may be the servant of two masters, not joint employers, at one time, as to one act, if the service to one does not involve the abandonment of the service to the other." Simultaneous employment is also illustrated in Rev. Rul. 73-447, which involved two nurses who worked an aggregate of 30 hours a week for two unrelated medical practices that shared facilities. The IRS determined that the nurses were full-time employees of both corporations for plan eligibility purposes because the amount of services rendered for each practice varied from day to day and the amount of services rendered to each practice was not determinative of full or part time status. Therefore, a retirement plan established by one of the practices and covering only one employee while excluding the nurses did not satisfy the applicable coverage requirements. Because a worker recruited by a PEO and placed with a client company is not in the service of the PEO in the manner envisioned by the Restatement, it is doubtful that such a worker could ever be the simultaneous employee of the PEO and the client.

The third option, that of the borrowed servant, is described in Restatement §227 as a servant directed or permitted by his master to perform services for another who becomes the servant of such other in performing the services. He may become the other's servant as to some acts and not as to the others. For a worker to be the common law employee of a PEO under this approach, the worker must first be the common law employee of the PEO.[455] The Supreme Court in the *Darden* case established that the status of an employee for purposes of ERISA and the I.R.C. is based on common law principles. Accordingly, the instances of dual employment identified in the Restatement should apply. Only the Ninth Circuit, by way of *dicta*, in the *Microsoft* case has endorsed the borrowed servant approach to date.[456]

Comment: The Ninth Circuit's analysis in this regard is perhaps flawed in two respects. First, it assumes that the staffing firm, rather than Microsoft, was the common law employer — a proposition urged by Microsoft and adopted by the court without undergoing a *Darden*-style analysis. But even if these workers were the common law employees of the staffing firm under a preponderance of the *Darden* factors, there is no basis in the Restatement for saying that the dual employment status operates simultaneously. The Restatement says that a servant directed or permitted by his master to perform services for another *may become* the servant of such other. The implication being that once the borrowed servant becomes the servant of the borrower, he or she ceases for the duration of that indenture to be the servant of the lender.

2. *TAM 199918056*

The application of the common law test of employee status and the manner in which that test is modified for certain purposes (but not others) where the revenue laws are concerned is illustrated in TAM 199918056. This TAM involved a staffing firm, the operations of which resemble those of a typical PEO. Client companies worked on projects in an industry in which it was customary to hire a worker for a single project. The worker could work for multiple client companies in the course of a year. At the start of a project, the staffing company and the client entered into a contract that characterized the staffing firm as the employer. The contract described the rate of pay, expense reimbursement arrangements, start date and hours. The client selected the workers and determined the type of work, number of hours worked and work schedule. The staffing firm reviewed time cards for compliance purposes, computed the workers' gross pay and applicable withholding, and prepared paychecks. Under the contract, the client was required to reimburse the staffing firm for payroll costs. The staffing firm reserved the right to control and supervise workers, but that right was subject to any instructions or requirements of the client.

On these facts, the IRS concluded that the client and not the staffing firm was the common law employer of the workers provided by the staffing firm. The staffing firm was nonetheless the statutory employer for withholding purposes under §3401(d)(1) because it paid wages from its own funds and otherwise maintained legal control over the payment of wages. But it was not the employer for purposes of determining a worker's wages for employment tax purposes under I.R.C. §3121(a)(1) and §3306(b)(1); rather, a separate wage base under those provisions applied to the compensation paid to a worker for the services performed for each client.[457]

3. *The PEO Industry and Co-Employment*

PEOs sometimes take over the workforces of their client companies. On one day, the worker is the employee of the client, and on the next day, he or she is the employee of the PEO and is placed with the client. The client continues to exercise control over and interface with the worker in much the same manner following the arrival of the PEO. On these facts,

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[455] §227 Restatement (Second) of Agency, Comments a and c provide in pertinent part that:

> Starting with a relation of servant to one master, he can become the servant of another master only if there are the same elements in his relation to the other as would constitute him a servant of the other were he not originally the servant of the first. Many of the factors stated in §220 which determine that a person is a servant are also useful in determining whether the lent servant has become the servant of the borrowing employer. (1958).

[456] *Vizcaino III*, 173 F.3d 713, 723 (9th Cir. 1999) (noting existence of the borrowed servant approach). The court observed:

> We agree that the assessment of the triangular relationship between worker, temporary employment agency and client is not wholly congruent with the two-party relationship involving independent contractors. In posing the question as the district court did, however, it set up a false dichotomy. Even if for some purposes a worker is considered an employee of the agency, that would not preclude his status as a common law employee of Microsoft. The two are not mutually exclusive… At common law, 'a servant … permitted by his master to perform services for another may become the servant of such other in performing the services.' Restatement (Second) of Agency §227 (1958).

Id.

[457] The definition of employer for purposes of §3121(a)(1) and §3306(b)(1) is not the same as the definition of employer for purposes of §3401(d)(1). *See* TAM 199918056 (discussing the nuances of employer definitions under each provision of the I.R.C.).

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it is difficult to argue that the worker is really the common law employee of the PEO. In order to overcome this problem, some PEOs assert that the workers are co-common law employees of the both the PEO and the client. If workers are employees of the PEO, notwithstanding their placement with a recipient employer, then they can be covered under the tax-qualified retirement plans and fringe benefit plans of the PEO without fear of disqualifying the plans or losing any of the tax advantages that accompany such arrangements. According to this view, the PEO and the client company, by contract, allocate some and share other traditional employer responsibilities and liabilities. The industry makes its case for co-employment in the following terms:

> The PEO relationship involves a contractual allocation and sharing of certain employer responsibilities between the PEO and the client, as delineated in a contract typically called a client service agreement (CSA)… The roles of the PEO and the client depend upon the facts and circumstances of each relationship — that is, each obligation should be examined individually as employment responsibilities are assigned in the parties' CSA. Each party will be responsible for certain obligations of employment, while both parties might share responsibility for other obligations and be "an" employer, but neither party is "the" employer for all purposes.[458]

The problem is that this approach lacks any firm statutory or regulatory support. No provision of the I.R.C. recognizes dual employment as such.[459] The I.R.C. does recognize instances in which someone other than the employer might be liable for collecting and remitting employment taxes and handling income tax withholding, but, with the exception of the dicta in the *Microsoft* case described above,[460] these authorities have never been extended to tax-qualified pension, profit sharing, and stock bonus plans or fringe benefit plans. Such a doctrine would have some unusual consequences where both the PEO and the recipient employer had their own tax-qualified retirement plans:

- If both employers had a defined benefit plan, then each employee would have to be counted by both entities in applying the minimum participation standards of §401(a)(26);
- An employee who satisfied the applicable eligibility rules could participate in both plans (unless the plan document contained a specific exclusion);
- Each employee could have two separate §415 limits — one for each plan;
- Hours of service would presumably be counted twice; and
- It is not clear as to whether, or under what rules, compensation could be allocated between the plans.

In support of dual employment, the PEO industry routinely cites the following rulings and cases:

(a) Rev. Rul. 66-162 involved a concessionaire that operated a leased department in a store as an independent contractor. The store considered the sales clerks in the department to be its employees and paid their salaries. But the concessionaire also directed and controlled the clerks and paid them commissions on their sales. In analyzing whether the concessionaire was liable for employment taxes on their commissions, the IRS observed that:

> A person may be the servant of two masters, not joint employers, at one time and as to one act, if the service to one does not involve abandonment of the service to the other (Restatement of the Law of Agency, 2d ed., §226, which has been cited with approval in court cases deciding common law employer liability in the area of tort law).

The IRS ruled that the sales clerks were employees of both the store and the concessionaire, and that the concessionaire was liable for employment taxes on the commissions. But this ruling pre-dated the enactment of §3121(s). Under that section, for FICA tax purposes, if two or more related corporations concurrently employ the same individual and compensate him through a common paymaster, then each corporation is considered to have paid as remuneration only the amounts actually disbursed by it to the individual and is not considered to have paid amounts actually disbursed by the other corporations. But if the related corporations do not compensate their common employees through a common paymaster (that is one of the employers), then the employee is treated as being employed by separate employers.

(b) Rev. Rul. 69-316 also presented the question of who is the employer, for purposes of FICA, FUTA and income tax withholding purposes. The ruling involved three groups of employees. Group (1) employees were employed by and performed services for a subsidiary of Y corporation but were paid by Y; group (2) employees handled accounting, auditing, and purchasing for Y and also

[458] National Association of Professional Employer Organizations, http://www.napeo.org/what-is-a-peo/about-the-peo-industry/what-is-co-employment.

[459] The IRS National Office advised that an entity's claim that it is the co-employer in a co-employment arrangement for federal employment tax purposes is not relevant under the I.R.C. when identifying the employer liable for employment taxes because the I.R.C., regulations, other formal guidance, and binding court precedent do not recognize co-employment or co-employer for federal employment tax purposes. TAM 201347020 (concluding that PEO asserting its client arrangements were co-employment arrangements did not have legal control over payment of wages, including deemed paid tip wages, to clients' employees; therefore, PEO was not §3401(d)(1) employer with respect to those wages and thus was not entitled to claim §45B credit for portion of employer Social Security taxes paid on tips). Although CCA 200017041 recognized the doctrine of co-employment at common law, it also noted the concept of a co-employer is not recognized in Subtitle C of the Internal Revenue Code (Employment Taxes and Collection of Income Tax). The I.R.C. provisions relating to tax-qualified plans are found in Subchapter D of Subtitle A of the I.R.C. Former Prop. Reg. §1.414(n)-1(d)(2) provided that the determination of who is the employer for purposes of §3121, §3306 and §3401 (relating to employment taxes and income tax withholding) is not determinative of who is the employer for purposes of Subchapter D. This regulation was issued before *Darden* and withdrawn after the case was decided. What is not clear is whether this sequence of events can be interpreted to mean that the IRS sees *Darden* as requiring a contrary result. But even if it does not, the support the co-employment doctrine proffered by the PEO industry is tenuous at best under current law.

[460] *Microsoft v. Vizcaino*, 97 F.3d 1187, 20 EBC 1873 (9th Cir. 1996), aff'd on reh'g, 120 F.3d 1006, 21 EBC 1273 (9th Cir. 1997), rem'd, 173 F.3d 713, 23 EBC 1209 (9th Cir. 1999), op. amended, 184 F.3d 1070 (9th Cir. 1999).

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for a number of its subsidiaries; and group (3) included executives of Y and one or more of its subsidiaries. The IRS applied the common law employee standards set out in Reg. §31.3121(d)-1(c) and, with respect to the group (3) employees, it also examined Reg. §31.3121(d)-1(b) (under which an officer of a corporation generally is considered to be an employee of the corporation). The IRS ruled that first, group (1) employees were employees of the subsidiary for which they performed services; second, group (2) employees (who performed services for both Y and its subsidiaries) were employees of Y only; and third, group (3) executives performed substantial services for each such corporation (and were, effectively, co-employees). The IRS also took note of the "control of wages" exception in §3401(d). As a result, Y was the employer of group (3) employees for this limited purpose.

Comment: It may well be that the simultaneous employment approach endorsed by these rulings is an accurate statement of the law as it applies in instances such as this. But to validly establish the co-employment status envisioned by §226 of the Restatement, the worker cannot abandon one employer in favor of another. Such abandonment is the hallmark of the PEO relationship. PEOs place workers with client companies without any intention that the worker will perform services for the PEO.

(c) *In re Earthmovers, Inc.*[461] involved an attempt by a bankrupt construction company to avoid employment tax liability where its employees had been transferred to a leasing company (Sunshine) subsequent to its bankruptcy filing. The primary issue in the case was whether Sunshine or Earthmovers was the statutory employer for the limited purpose of income tax withholding. For this purpose, the court looked to §3401(d)(1), under which the person or entity having control over the payment of wages is deemed to be the employer for income tax withholding purposes. In an effort to place the liability on Sunshine, Earthmovers advanced a two-pronged argument. It first claimed that it did not have control over the payment of wages. The court rejected this argument as disingenuous. Earthmovers had to calculate and submit information with respect to hours worked each week; it was required to forward amounts sufficient to cover payroll to Sunshine; and it retained the right to hire and fire employees. Earthmovers next attempted to invoke Fla. Stat. §468.525(4), under which staffing firms assumed responsibility for the payment of payroll taxes. The court rejected both arguments, holding instead that Earthmovers was liable for the employment taxes. In so holding, the court characterized Sunshine and Earthmovers as de facto co-employers. It does not appear that this holding was necessary to the court's overall holding. But even if it was, the case deals with employment taxes and not the tax treatment of retirement or fringe benefit plans.

On appeal by Sunshine, the district court determined that, because all employment taxes had been paid, it was not necessary for the bankruptcy court to determine which entity was the employer. Accordingly, the court expressed doubt that Sunshine had standing (as it was not an aggrieved party). Additionally, the court pointed out that the administration of the Chapter 11 proceeding had been completed and a final decree entered, closing the case. Thus, the question of whether Sunshine was liable as an employer was moot.[462]

There are a few instances in which a staffing company has been held to be the employer without any mention of dual employee status. Rev. Rul. 75-41, discussed in IV.A.2.c., involved a staffing firm that provided a variety of services to professional practices (referred to in the ruling as subscribers), including the services of secretaries, nurses, dental hygienists, and other similarly trained personnel. The staffing firm recruited, hired and trained the workers, paid their wages, and provided them with liability and unemployment insurance, workers' compensation, and other benefits. It placed the workers with subscribers under a written contract that specified the services to be provided and the fee to be paid to the staffing firm. Although subscribers could ask to have a worker replaced within a reasonable period of time, they did not have the right to affect the contract between the worker and the staffing firm. The staffing firm had the right to remove or reassign any worker, but it was obligated to either furnish a replacement or adjust the fee. The workers agreed to be available to perform services for any subscribers to which they were assigned. The staffing firm had the right to evaluate the performance of the workers and to discharge them if the evaluation showed that they did not satisfactorily perform the services. Workers who entered into contracts with the corporation agreed that they would not contract directly with any subscriber to which they were assigned for at least three months after cessation of their contracts with the corporation. Based on Reg. §31.3121(d)-1, §31.3306(i)-1, and §31.3401(c)-1 (that generally follow the common law rules), the IRS ruled that the staffing firm was the employer for purposes of FICA, FUTA, and federal income tax withholding.

Comment: Rev. Rul. 75-41 is unremarkable in two important respects: It states that for purposes of Federal employment taxes the usual common law rules ordinarily apply in determining whether the employer-employee relationship exists and, if so, who is the employer. The ruling does not mention co-employment. Nevertheless, it can be interpreted to mean that, for payroll and withholding purposes at least, a company can be the employer even though it lacks day-to-day control over the worker sufficient for the worker to be its common law employee. Because the test for common law employee status is the same for tax-qualified plan purposes, does this mean that the ruling can be extended to such plans? For this to be the case,

[461] 199 B.R. 62, 67 (Bankr. M.D. Fla. 1996). *See United States v. Total Emp't Co.*, 305 B.R. 333 (M.D. Fla. 2004) (under state statutory framework, client in an employee leasing arrangement is common law employer of leased employees and employee leasing company is statutory employer; both are responsible for withholding on employee income and for collection and payment of payroll taxes; client bears ultimate responsibility and is liable to employee leasing company when leasing company pays or is held liable to the IRS); TAM 201347020 (disagreeing with *Total Emp't Co.* holding regarding dual liability); CCA 201724025 (PEO not a statutory employer under §3401(d)(1) because, based on contract, it lacked control over payment of wages and thus its payroll actions were merely that of a conduit; taxpayer, as common law employer, not relieved of employment tax responsibilities despite PEO's failure to remit funds received from taxpayer to the government); FAA 20171201F (same).

[462] *Sunshine Staff Leasing, Inc. v. Earthmovers, Inc.*, 242 B.R. 49 (M.D. Fla. 1999).

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it would need to be possible for a tax-qualified plan to cover workers over which the plan sponsor lacks the requisite level of control to make the workers its common law employees. This would appear to fly in the face of the exclusive benefit rule — a rule that for obvious reasons has no parallel in the employment and withholding tax rules.

Rev. Rul. 70-630 involved a salesclerk trained by a service company and placed with a retail store to perform temporary sales services. The service company was formed for the purpose of training salesclerks and other temporary personnel and furnishing them to retail establishments that may require the services of additional salesclerks during special sales and other periods of high demand. The service company trained the individuals to perform sales services in conformity with the established procedure of the store. The service company also placed a supervisor in each store to which salesclerks were furnished. The supervisor determined whether the clerks were neat in appearance and dressed in accordance with the store's policies and made periodic reports to the service company showing the number of hours each clerk worked and the number of sales made. The salesclerks were subject to the instructions and control of the supervisor and not the store's personnel. The store was required to accept the clerks assigned to it, but it could request the removal and reassignment of any clerks that proved to be unsatisfactory. The service company carried public liability, workers' compensation, and liability insurance on the salesclerks. The store paid the service company a stipulated amount for the services furnished and the clerks received a standard wage directly from the company. Based on Reg. §31.3121(d)-1, §31.3306(i)-1, and §31.3401(c)-1, the IRS ruled that the service company was the employer for FICA, FUTA and income tax withholding purposes.

Comment: Both authorities suggest that a PEO with real management responsibilities may well be the common law employer. While not explicitly treated in either ruling, the PEO is more likely to be the employer if its obligation to pay employment taxes is not subject to the advance receipt of monies from the client company, or the client company's prior deposit of funds in trust for that purpose. The constraints imposed on a worker's ability to go to work for a recipient for a significant period of time following the termination of employment with the staffing firm also indicates that the relationship between the PEO and the worker is an employment relationship rather than a mere agency relationship. These factors are not commonly encountered in the typical PEO contract or arrangement. But even if it is established that the PEO has real management responsibility, dual employment status does not follow. If on the other hand the PEO merely places the worker, handles payroll and furnishes benefits, but the recipient has broad discretion to assign additional work, etc., or if the leasing company or PEO nominally has control but the facts and circumstances indicate that the leasing company is acting as the mere agent of the service recipient, then the worker is more likely to be the common law employee of the service recipient.[463] Either way, there is no authority under which the workers may be treated as co-employees of the PEO and the recipient for employee benefits purposes.

In *Burnetta v. Commissioner*,[464] the Tax Court was asked to decide whether certain medical office personnel were employees of the medical practice or the staffing firm through which the employees were retained. At stake was the tax-qualified status of the pension and profit-sharing plans maintained by Burnetta's medical corporation. (This case was decided prior to the enactment of §414(n) governing the treatment of leased employees.) As originally envisioned, the staffing firm intended to handle the selection, hiring, training, and instruction of workers who would in turn be contracted out, but in practice this turned out not to be the case. In operation, the court determined that the staffing firm essentially provided payroll and record-keeping services for its clients. Its promotional brochure was telling in this regard. It provided, in pertinent part:

> Most businessmen appreciate the value of a good employee. But along with the service they perform, employees also create more work. Calculating payroll, writing checks, keeping records, making federal, state and city reports. Did you know that in 1972, a business with only one employee comes under the federal unemployment tax law? More records — more reports — more of your valuable time! Wouldn't it be nice if you could have your employees, without the burden of payroll? Well, you can! With our service your employees become our employees. *The same loyal employees you have now continue to work under your direction and at the rate of pay you determine; but we do all of the work connected with payroll.* (Emphasis added.)

According to the Tax Court, the medical practice determined the initial rate of the workers' pay as well as any subsequent increases or decreases. The staffing firm prepared and mailed the salary checks after making the appropriate payroll deductions for such items as Social Security, and federal and state income taxes. On these facts, the Tax Court determined that workers furnished though the staffing firm were the common law employees of the medical practice, and as a consequence the pension and profit sharing plans were disqualified.

4. PEOs and (Statutory) Leased Employees

The cases and authorities described above establish a continuum on which employee status might be plotted. At one end of the spectrum is the situation in which the PEO is the mere payroll agent of the client company. The worker in this instance is the employee of the client based on the *Darden* factors. While this situation is most clearly demonstrated if the PEO simply handles payroll and nothing more, this may well describe a large majority of PEO arrangements. At the other end of the spectrum are the arrangements described in Rev. Rul. 75-41 and Rev. Rul. 70-630, in which the contacts with the PEO were so strong as to result in the worker being treated as the employee of the staffing firm and not the client. In the middle is the glimmer of dual employment that, despite industry protests to the contrary, has proven to be illusive at best. The

[463] *See Burnetta v. Commissioner*, 68 T.C. 387, 1 EBC 1724 (1977) (finding medical corporation was common law employer and leasing company was a mere bookkeeping service).

[464] 68 T.C. at 391–92.

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doctrine of dual employment depends on there being a midpoint in the continuum at which the *Darden* factors are evenly balanced between the client and the PEO.

In an effort to establish dual employment, PEOs are designing placement programs under which more and more of the *Darden* factors remain with the PEO. This effort is based on the premise that, at some point, the factors will balance so evenly as to produce co-employment. This premise assumes that the *Darden* factors operate on a continuum the midpoint of which may be identified with certainty. But the current regulatory structures operate more like a binary decision model with "employee" and "non-employee" being the only nodes or options. In this model, there is no such midpoint. One possible, unintended consequence of this effort to establish dual employee statutes is that the workers will be determined to be the common law employees of the PEO and statutory leased employees of the client. If so, then the consequences appear to be beneficial:

(a) The PEO will be free to cover the worker under its plans with impunity. For purposes of coverage, vesting, contributions and benefits, a plan maintained by the PEO will need to take into consideration all of the leased employee's service with the PEO, including periods during which the employee was leased to the client company.[465]

(b) The client company will be able to cover the worker under its plan without violating the exclusive benefit rule. Under §414(n)(1)(B), contributions made by the PEO to its plan with respect to services furnished to the client are treated as having been provided by the client. The client company's plan will, as a result, need to aggregate the PEO's contributions on the recipient's behalf with any contributions to its own plan for purposes of applying the limits imposed by §415, and it can take them into account for purposes of satisfying the top-heavy rules of §416.

(c) If the PEO maintains a safe harbor plan under §414(n)(5), then the client company will be able to exclude the worker from its plans for all purposes.

(d) Many of the same results accrue where employee welfare and fringe benefits are concerned. Statutory leased employees are treated as the employees of the recipient in applying a host of fringe benefit nondiscrimination rules including group-term life insurance plans, self-insured accident and health plans, qualified tuition reduction arrangements, cafeteria plans, educational assistance programs, dependent care assistance plans, adoption assistance programs, employee achievement awards and certain other fringe benefits.

While this approach has at least some of the benefits that purportedly flow from dual employee status, it is unlikely to be widely adopted. The principal problem with any attempt to wrest employee-status from a worker hired through a PEO away from the client is that, in most cases, the day-to-day supervision and control of the worker is with the client and not the PEO. This is particularly true where a PEO takes over a client's existing workforce. Nonetheless, there may be cases where this model benefits both the PEO and the client.

[465] Notice 84-11, Q&A-13.

5. PEO Maintenance of Employee Benefit Plans

If the PEO industry's claims of dual employee status prove incorrect as applied to tax-qualified retirement plans and fringe benefit plans, then some potentially serious compliance problems, both for the PEO and the client company/recipient, are likely to follow.

a. PEO Plan

If the workers employed through a PEO are determined to be the common law employees of the recipient only, and if the workers are covered under a tax-qualified plan maintained by the PEO, then there are at least two possibilities: Either the plan of the PEO is disqualified by reason of an exclusive benefit violation resulting from the coverage of non-employees, or the plan is treated as a multiple employer plan under §413(c). If the plan is treated as a multiple employer plan, then eligibility and vesting are determined employer-by-employer,[466] and then nondiscrimination testing is required to be performed plan-by-plan.[467] Multiple employer plans also carry with them some additional risks for the PEO and the client companies alike. All of the assets of such plans must be available to pay all plan benefits, and if any one of the participating employers violates the terms of the plan, the plan is disqualified as to all participating employers.[468]

A plan risks disqualification if it provides benefits for individuals who are not employees of the employer maintaining the plan because the plan will not satisfy the exclusive benefit rule of §401(a)(2). Rev. Proc. 2002-21 provided limited relief to PEOs that maintained a defined contribution plan to instead establish a multiple employer plan or terminate the plan under certain conditions to prevent the plan from being considered disqualified. PEO retirement plans that were in existence as of May 13, 2002 could have been converted to a multiple employer plan (MERP) using plan amendments, to be completed by the last day of the first plan year beginning on or after January 1, 2003; for a calendar year plan, the compliance date was December 31, 2003.[469] The PEO had to notify all client organizations with worksite employees that had vested benefits in the PEO retirement plan and provide each client organization with the option of:

- adopting the multiple employer plan;

[466] Reg. §1.413-2.

[467] §413(c); Reg. §1.413-2.

[468] *See* Reg. §1.413-2(a)(3)(iv). For plan years beginning after 2020, however, certain multiple employer defined contribution plans that have a pooled plan provider or are maintained by employers having a common interest are not disqualified due to the bad acts of one or more participating employers. §413(e)(1), added by the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), Pub. L. No. 116-94, Div. O, §101(a), effective for plan years beginning after December 31, 2020. *See* Prop. Reg. §1.413-2(a)(3)(iv) and §1.413-3, REG-121508-18, 87 Fed. Reg. 17,225 (Mar. 28, 2022), proposed to apply beginning on the date of publication in the Federal Register of the Treasury decision adopting these rules as final regulations. For discussion of pooled plan providers and the requirements for this relief from the unified plan rule, see 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans.*

[469] Rev. Proc. 2002-21, §4.

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• transferring the vested PEO pension balance of each worksite employee to the client organization's retirement plan; or

• having the assets and liabilities of the PEO retirement plan attributable to the client organization's worksite employees spun off to a spin-off retirement plan, which had to be terminated.[470]

Alternatively, the PEO could have terminated its retirement plan, commensurate with a resolution from its board of directors, and distribute assets "as soon as administratively feasible." The PEO had to give a client organization the option to either transfer such assets to its own plan or spin off assets to a spin-off retirement plan and then terminate the plan.[471]

Furthermore, the PEO had to request determination letters on the termination of its retirement plan and the spin-off plan within one year of termination.

Rev. Proc. 2003-86 provided additional guidance on certain transitional issues raised by practitioners following the release of Rev. Proc. 2002-21. A PEO electing to use the transitional rules under Rev. Proc. 2003-86 had to adopt conforming plan amendments for a MERP no later than the last day of the EGTRRA remedial amendment period. The EGTRRA remedial amendment period was to end no earlier than the last day of the first plan year beginning on or after January 1, 2005, but was extended in Rev. Proc. 2005-66[472] to the end of a plan's initial remedial amendment cycle.[473]

Issues addressed by Rev. Proc. 2003-86 include: (1) whether a spin-off retirement plan could make distributions on terminating the plan in accordance with §5.04(2) of Rev. Proc. 2002-21 to worksite employees who perform services for a client organization (CO), if, following termination of the PEO plan or conversion of the PEO plan to a MERP, the CO maintained a defined contribution plan for its employees or if the PEO maintained another plan that covered the PEO's own employees; (2) how the §416 top-heavy rules applied with respect to participants' benefits that accrued in a PEO plan by its compliance date after a PEO converted to a MERP; (3) how the ADP and ACP tests applied to a MERP in the first plan year; (4) how a required distribution was calculated for the first calendar year for which a distribution was required and when such a distribution had to occur with respect to worksite employees who attained age 70½ but had not yet retired, and who would be treated as 5% owners of a CO in the first plan year of the MERP; and (5) when an individual was a worksite employee in the year preceding the first plan year of the MERP, whether compensation received by such individual during that year was taken into account in determining whether the individual was a highly compensated employee (as defined in §414(q)(1)), in the first plan year of the MERP.

Despite some risks, MERPs maintained by PEOs offer a more promising approach than dual employment. The former has the benefit of a statutory basis. Such plans are sometimes designed to have the look and feel of master or prototype arrangements, but they are individually designed plans. They usually include a menu of variables that can be elected by each plan sponsor for such things as allocation methods, §401(k) provisions, vesting, and eligibility. If a PEO includes all of the employees placed by the PEO with client companies as well as the PEO headquarters group, then employer-by-employer nondiscrimination testing would require that the headquarters employees stand on their own for testing purposes.

Example: PEO Z has four client companies, Company A through Company D. PEO Z maintains a §401(k) plan that allows for elective deferrals and includes a matching contribution of 50% of elective deferrals. The plan covers all of the non-excludible employees of the PEO and each client company. The deferral ratios are set out below:

Employer	HCE ADP/ ACP	NHCE ADP/ ACP
All (PEO plus Companies A–D)	7.26%/3.63%	6.64%/3.32%
PEO	8.8%/4.4%	5.6%/2.8%
Company A	4.1%/2.05%	4.6%/2.3%
Company B	3.0%/1.5%	3.6%/1.8%
Company C	7.8%/3.9%	6.8%/3.4%
Company D	12.6%/6.3%	12.6%/6.3%

If the PEO is correct in its claim that the workers placed with the client companies are co-employees, then all the employees of the PEO and each client are aggregated for purposes of performing the ADP, ACP, and multiple use tests, and the plans pass.[474] But if the plan is tested employer-by-employer, then the portion of the plan covering the PEO headquarters group will fail.[475]

b. Recipient's Plan

If these same workers are also excluded from the plans of the recipient based on their being provided through a PEO, then the result is an improperly excluded employee, and the situation is similar to that encountered in the *Microsoft* case.

Welfare and fringe benefit plans also are affected. If the PEO's reliance on the doctrine of co-employment is misplaced, and if workers placed with a client company are covered under a PEO-sponsored welfare benefit plan, then there are again at least two possibilities: Either the tax benefits are lost to the employees of the client or the plan is recast as a multiple employer welfare arrangement (MEWA). (Accidental MEWAs are discussed in IV.D.) At a minimum, this will trigger potentially burdensome federal and state filing requirements.

6. Mirror Plans

Under a mirror plan arrangement, the PEO and the client adopt identical or nearly identical plans. Proponents of this

[470] Rev. Proc. 2002-21, §5.

[471] Rev. Proc. 2002-21, §5.

[472] *Modified and superseded by* Rev. Proc. 2007-44, *modified by* Rev. Proc. 2008-56, and *modified and superseded by* Rev. Proc. 2016-37 (effective January 1, 2017).

[473] Notice 2005-95. See 360 T.M., *Qualified Plans — IRS Determination Letter Procedures*, for a discussion of the EGTRRA remedial amendment period.

[474] §401(k)(2), §401(m)(3).

[475] §401(k)(2), §401(m)(3).

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view claim that workers get the correct (and presumably nondiscriminatory) level of benefit irrespective of their proper classification and, as a result, the IRS is unlikely to raise any qualification concerns.[476] While these arguments may be true, it is almost assured that the mirror retirement plans would be multiple employer plans (in the case of tax-qualified retirement plans) or multiple employer welfare plans (in the case of welfare plans) unless each worker was at all times properly classified. By design, the mirror plan approach anticipates that workers will be misclassified and attempts to ensure that they will not be deprived of benefits as a result.

Comment: Proponents of the multiple employer plan approach claim that workers are properly covered irrespective of the true identity of the common law employer. While the argument is appealing, it addresses only the exclusive benefit issue. Nondiscrimination testing in the multiple employer plan context is performed plan sponsor by plan sponsor. It is, therefore, still possible to fail one or more of the applicable nondiscrimination tests when workers are misclassified. Moreover, the qualification requirements are applied to a multiple-employer plan based on the plan as a whole under Reg. §1.413-2(a)(3)(iv). The actions of one employer — however inadvertent — could cause total disqualification of the plan.

7. Revenue Procedure 2002-21

Rev. Proc. 2002-21 addressed squarely the application of the exclusive benefit rule under I.R.C. §401(a)(2) to tax-qualified retirement plans maintained by PEOs, while at the same time carefully sidestepping the question of employee classification. Specifically, Rev. Proc. 2002-21 provides that, after the 2003 plan year, a PEO itself may no longer maintain a tax-qualified plan for workers that perform services for its client companies. PEOs were instead given the option to either convert an existing plan into a multiple employer plan, in which case client companies could elect to become participating employers, or terminate the plan. Rev. Proc. 2002-21 further provides PEOs with a procedure to avoid the consequences of their prior exclusive benefit rule violations.[477]

Rev. Proc. 2002-21 defines the terms "Client Organization" (CO) and Worksite Employees,[478] but it nowhere defines the term "Professional Employer Organization." It also defines the following terms:

- *PEO Retirement Plan.* This is a defined contribution plan (such as §401(k) plan or profit sharing plan) intended to satisfy §401 or §403(a), sponsored solely by a PEO and covering worksite employees. Multiple employer plans and defined benefit plans are not covered by Rev. Proc. 2002-21.[479]
- *Multiple-Employer Retirement Plan.* This is a defined contribution plan under §401, §403(a) or §413(c) cosponsored by the PEO and by COs with participating employees.[480]
- *PEO Decision Date.* This is 120 days after the first day of the PEO's plan year beginning after December 31, 2002.[481]
- *Compliance Date.* This is the last day of the plan year beginning in 2003. In order for a PEO to have relief, essentially everything had to be completed by this date.[482]
- *Effective Date.* May 13, 2002.[483] Plans adopted after this date cannot use Rev. Proc. 2002-21.[484]
- *Spinoff Retirement Plan.* This is a plan set up to hold the assets and liabilities of worksite employees whose CO chose a spinoff or failed to notify the PEO of its desired course of action. The Spinoff Retirement Plan was to be terminated prior to the Compliance Date and assets distributed as soon as possible.[485]

a. Purpose of Rev. Proc. 2002-21

PEOs have encountered stumbling blocks in several areas, including the area of tax compliance. This is because the I.R.C. provides that the employer is ultimately liable for HR-related tax functions, such as the withholding and payment of income and taxes. Also, the exclusive benefit rule of §401(a)(2) generally requires that only employees of employers maintaining a tax-qualified retirement plan participate in the plan. For tax purposes, the analysis generally focuses on the identity of the entity that has the right to direct and control the individual performing the services. Because of this, the identity of the employer is critical.

PEOs routinely claim to be either the common law employer of their worksite employees, or to be a co-employer of those workers with the CO. In instances where the CO is found to be the common law employer, which is often the case for tax and benefit purposes, a PEO plan covering these workers will violate the exclusive benefit rule.[486] In response to this concern, some PEOs elected not to set up retirement plans. Others ignored the issue and established single-employer plans. These single employer plans are the focus of Rev. Proc. 2002-21. Taking a conservative approach, some PEOs set up multiple employer plans with the COs who participate. PEOs who were already sponsoring such multiple employer plans prior to 2002 are unaffected by Rev. Proc. 2002-21.[487]

Rev. Proc. 2002-21 does not address whether a PEO is the employer of its workers, nothing that this is a facts and circumstances determination. Rather, it provides that:

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[476] Allen Buckley, *Employee Leasing Rules Present Problems*, 27 Tax Mgmt. Compensation Plan. J. 235, 241 (Sept. 1999).

[477] *See* S. Derin Watson, *Who's the Employer? A Guide to Employee and Aggregation Issues Affecting Qualified Plans*, 6-1 (4th ed. 2005).

[478] "Client Organization" means an organization that enters into a service agreement with a PEO under which Worksite Employees provide services to the organization. Rev. Proc. 2002-21, §6.05. "Worksite Employees" means employees who receive amounts from a PEO for providing services to a CO pursuant to a service agreement between the PEO and the CO. Rev. Proc. 2002-21, §6.04.

[479] Rev. Proc. 2002-21, §6.01.

[480] Rev. Proc. 2002-21, §6.02.

[481] Rev. Proc. 2002-21, §4.02(2).

[482] Rev. Proc. 2002-21, §4.02(1).

[483] Rev. Proc. 2002-21, §9.

[484] Rev. Proc. 2002-21, §4.01.

[485] Rev. Proc. 2002-21, §6.03.

[486] Rev. Proc. 2002-21, §3.02 (citing *Professional and Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225 (1987), aff'd, 862 F.2d 751 (9th Cir. 1988)).

[487] §413(c)(2); Rev. Proc. 2002-21, §6.01.

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• a PEO Retirement Plan would violate the exclusive benefit rule and thus be disqualified if it covered individuals who were not its employees;

• a PEO following the revenue procedure instructions would not be treated as maintaining a retirement plan that violated the exclusive benefit rule solely because benefits were provided to Worksite Employees; and

• a PEO not electing to take advantage of the revenue procedure for a PEO Retirement Plan was not maintaining a retirement plan that was protected from any qualification violation, including violation of the exclusive benefit rule, and could not rely after 2003 on any determination letter that it had received.

The consequence of being unable to rely on a favorable determination letter is so severe that few PEOs chose to forgo the opportunity to use Rev. Proc. 2002-21. The PEOs either terminated their existing single-employer plans or converted them to multiple employer plans, whether or not the PEOs believed they were the common law employer of their worksite employees. Thus, through Rev. Proc. 2002-21, the IRS achieved the result of eliminating most or all single-employer PEO plans without having to determine, on a case-by-case basis, whether a given PEO is the employer of its workers. This enabled PEOs to avoid the consequences of their prior exclusive benefit violations, and thus maintain the qualified status of their plans.

b. Benefits of Complying with Rev. Proc. 2002-21

If a PEO Retirement Plan in existence on May 13, 2002, complied with the requirements of Rev. Proc. 2002-21, it received the following relief:

• The IRS did not disqualify the PEO Retirement Plan solely on account of an exclusive benefit rule violation under §401(a)(2) for a plan year beginning before the Compliance Date if that violation resulted from the PEO retirement plan benefiting Worksite Employees who are not the PEO's employees.[488]

• Employees receiving distributions after termination of the Spinoff Retirement Plan or the terminating PEO Retirement Plan were able to treat those distributions as coming from a qualified plan, even though the plan may have violated the exclusive benefit rule.[489]

• For purposes of determining whether the Spinoff Retirement Plan or the PEO Retirement Plan (if the PEO elected to terminate it) is qualified upon termination, Worksite Employees could be treated as though they were common law employees of the PEO. In effect, this allowed the PEO, if it decided to terminate, to file for a determination letter on termination without having to rerun all of its coverage and nondiscrimination testing since inception considering only its own employees. This rule was applicable only to terminating plans.

c. Consequences of Not Complying with Rev. Proc. 2002-21

Serious consequences are faced by a PEO sponsoring a single-employer PEO sponsored retirement plan that falls in any of the following four categories: (i) the PEO chose not to comply with Rev. Proc. 2002-21, (ii) the PEO did not timely comply with all the revenue procedure's requirements, (iii) the PEO sponsored a defined benefit plan and therefore was not eligible for relief under the revenue procedure, or (iv) the PEO adopted a single-employer plan after May 13, 2002, and therefore was not eligible for relief under the revenue procedure. In any of these situations, the PEO is unable to rely on the relief promised in Rev. Proc. 2002-21. Therefore:

• The PEO is at risk for disqualification under the exclusive benefit rule as a result of including worksite employees who are not its common law employees.

• Participants receiving distributions who elect to roll over those distributions are at risk for the IRS finding that the rollovers were improper. Accordingly, the distributions are taxable and the participants are subject to a tax penalty on excess IRA contributions.

• The PEO would need to rerun any nondiscrimination, ADP, ACP, and coverage tests based only on its employees. It would not consider worksite employees that are not its common law employees.

Furthermore, if there is a single-employer PEO sponsored defined contribution plan covering worksite employees, then as of the first plan year beginning after 2003, it cannot rely on any determination letter, regardless of the date of the letter.[490]

A PEO plan established after May 13, 2002 cannot receive the relief available through Rev. Proc. 2002-21. It is subject to all consequences of noncompliance. In addition, a PEO sponsored defined benefit plan may not receive the relief of Rev. Proc. 2002-21. This may be a moot point, because there are virtually no dedicated PEOs that have defined benefit plans.

d. Procedure for Compliance with Rev. Proc. 2002-21

If a PEO wished to comply with Rev. Proc. 2002-21, then on or before the PEO Decision Date, the PEO must have done the following:

• Decided either to terminate its existing PEO Retirement Plan in accordance with §5.02, or convert the PEO Retirement Plan into a multiple employer plan ("Multiple-Employer Retirement Plan") in accordance with §5.03.[491]

• Notified all COs with Worksite Employees participating in the existing plan of the choice of having the assets and liabilities of the PEO Retirement Plan attributable to its workers transferred to a retirement plan maintained by it or a Spin Retirement Plan, which would then be terminated.[492]

The PEO had to act in accordance with the choices made by the CO. Compliance had to be completed by the Compliance

[488] Rev. Proc. 2002-21, §4.01.
[489] Rev. Proc. 2002-21, §5.06(2).
[490] Rev. Proc. 2002-21, §5.09.
[491] Rev. Proc. 2002-21, §5.02 and §5.03.
[492] Rev. Proc. 2002-21, §5.02(2) and §5.03(3).

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Date (the last day of the 2003 plan year), although terminating distributions could take longer to complete. The PEO also had to seek determination letters for its plans.

8. *PEO Liability Under ERISA: COBRA Continuation Coverage*

The Consolidated Omnibus Budget Reconciliation Act of 1985[493] (COBRA) amended both ERISA and the I.R.C. to impose health care continuation requirements on most group health plans. Under COBRA, a group health plan must offer certain current and former employees and their covered dependents the opportunity to continue coverage upon the occurrence of certain qualifying events that result in the loss, or changes in the terms, of group health plan coverage. The employer must offer continuation coverage to employees and their spouses for at least 18 months following the qualifying event.[494] COBRA imposes obligations on both employers and plan administrators. COBRA requires group health plans to provide written notice of COBRA rights to each covered employee at the time coverage under the plan commences.[495] When a qualifying event occurs, the plan administrator must furnish additional notice of the right to elect continuation coverage.[496] A plan administrator that fails to meet either or both of these notice requirements may be personally liable to the employee in the amount of up to $110 a day from the date of the failure.[497] For a detailed discussion of COBRA and related issues, see 338 T.M., *COBRA — Consolidated Omnibus Budget Reconciliation Act of 1985*.

Compliance with COBRA is further complicated where employees are employed by a PEO, with the most daunting issues arising where group health coverage — offered by either the PEO or the client company — begins or ends in connection with the establishment or termination of the PEO relationship. *Delcastillo v. Odyssey Resource Management, Inc.*[498] addressed liability under ERISA and COBRA where a PEO failed to provide notice to workers regarding both COBRA options and COBRA continuation coverage.

Delcastillo involved a worker who was severely injured on the job in 1996 when he fell from a railcar. After the accident, John Delcastillo received workers' compensation, and he and his wife continued to receive employer-provided health insurance. Delcastillo's employer subsequently contracted with a PEO, Odyssey Resource Management, Inc. (Odyssey), to act as a co-employer and COBRA administrator, and the employer switched its health insurance to Odyssey's policy effective February 1, 1999.[499] A month later, the Delcastillos were informed by health care providers that they had no coverage. In response to the Delcastillos' inquiries, Odyssey claimed that a mistake had been made and provided the couple with enrollment forms, insurance cards, and health plan documents. However, health care providers continued to advise the couple that they had no coverage.

Later in 1999, Odyssey wrote to the couple, offering them retroactive coverage for a limited period, subject to their agreement not to seek COBRA coverage. The couple finally received COBRA election notices in July 2000. At that time, the couple had incurred $27,000 in medical expenses. The couple brought an action seeking damages and equitable relief under ERISA, arguing that the PEO had failed to provide adequate COBRA notices and had breached its fiduciary duties.

The district court held the Odyssey defendants jointly and severally liable for statutory penalties based on their failure to give both an initial COBRA notice of the Delcastillos' statutory right to continuation coverage after a qualifying event, and their failure to give timely notice of a qualifying event.[500] The court further held the Odyssey defendants liable for the Delcastillos' unpaid medical expenses based on affirmative misrepresentations as to coverage made after the Odyssey plan took effect on February 1, 1999. The court awarded an amount representing reimbursement of the Delcastillos' unreimbursed medical expenses and penalties for failure to provide notice and information under ERISA §502(c)(1)(A) and ERISA §502(c)(1)(B).

On appeal, the Eighth Circuit Court of Appeals reversed and remanded, finding:

- Delcastillo was still covered under replacement coverage provision of existing policy when employer changed group health insurance providers;
- Delcastillo was not entitled to an additional initial notice under COBRA at the point in time when employer changed group health insurance providers or when another company purchased employer's assets and was substituted as policy holder; and
- Delcastillo was not entitled to initial notice under new plan until replacement coverage provision of existing group health insurance plan was terminated. The court found that the termination date was June 30, 2000.

In addition, the Court of Appeals intimated that a decision to engage PEOs as co-employers in order to alter participants' rights to ERISA benefits might well violate ERISA fiduciary duties.[501]

On remand, the district court found Odyssey liable for wrongful denial of benefits under ERISA §502(a)(1)(B). Accordingly, the court found Odyssey liable for medical expenses that would have been covered had the Delcastillos elected COBRA coverage, as well as medical claims improperly denied from February 1, 1999 to June 30, 2000. The court assessed statutory penalties under ERISA §502(c)(1)(B) against Odyssey in the amount of $110.00 per day for the 176-day period during which no summary plan description or documents were forwarded to plaintiffs despite their repeated requests.[502]

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[493] Pub. L. No. 99-272, §10002(a).

[494] ERISA §301(a), ERISA §602(2), ERISA §603.

[495] ERISA §606(a)(1), 29 C.F.R. §2590.606-1.

[496] ERISA §606(a)(4), 29 C.F.R. §2590.606-2.

[497] ERISA §502(c)(1); 29 C.F.R. §2575.502c-1.

[498] *Delcastillo v. Odyssey Resource Mgmt., Inc.*, 479 F. Supp. 2d 1087, 41 EBC 1180 (D. Neb. 2007), rev'd per curiam, 292 Fed. Appx. 519 (8th Cir. 2008) (unpub. op.).

[499] *Delcastillo v. Odyssey Resource Mgmt., Inc.*, 431 F.3d 1124, 1127 (8th Cir. 2005). As a co-employer, Odyssey was responsible for complying with COBRA and ERISA for any plans it administered. *See Employers Res. Mgmt. Co., Inc. v. Shannon*, 65 F.3d 1126, 19 EBC 1982 (4th Cir. 1995).

[500] *Delcastillo v. Odyssey Resource Mgmt., Inc.*, 320 F.Supp. 2d 889, 32 EBC 3009 (D. Neb. 2004).

[501] *Delcastillo v. Odyssey Resource Mgmt., Inc.*, 431 F.3d 1124, 36 EBC 1705 (8th Cir. 2005).

[502] The court adjusted the amount of the award and statutory fees in subsequent proceedings. *Delcastillo v. Odyssey Resource Mgmt., Inc.*,

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9. PEO Sponsorship of a Multiple Employer Plan: DOL Rule

a. Single Employer Treatment

The DOL issued a rule intended to allow more workers access to workplace retirement savings plans through a multiple employer plan (MEP).[503] The rule, which is effective September 30, 2019, sets out the conditions that must be met for a bona fide PEO (or an employer group or association) to act in the interest of an employer under ERISA §3(5) to establish or maintain a workplace retirement plan that is a single multiple employer defined contribution plan (or association retirement plan) under Title I of ERISA,[504] instead of an arrangement that constitutes multiple retirement plans. Under the regulation, bona fide PEOs (and bona fide employer groups or associations) may act in the interest of an "employer" for purposes of sponsoring a MEP under ERISA §3(34) that constitutes a multiple employer retirement plan (or an association retirement plan).

The regulation interprets the term "employer" for purposes of ERISA §3(5) using more flexible standards and criteria for sponsorship of these MEPs than those contained in pre-existing DOL subregulatory interpretive rulings under ERISA §3(5), and it supersedes those advisory rulings as of September 30, 2019.[505] The DOL cautioned that a PEO's status under the rule does not change the likelihood of whether the PEO has joint employer status with a client employer for purposes of other laws and liabilities.[506]

b. Bona Fide Professional Employer Organization

Under the DOL regulation, a "bona fide professional employer organization" (bona fide PEO) is capable of establishing a multiple employer plan that is an defined contribution retirement plan. A bona fide PEO is deemed to be able to act in the interest of its client employers within the meaning of ERISA §3(5) if it meets the criteria for (1) a bona fide PEO and (2) substantial employment functions.[507]

A PEO qualifies as a bona fide PEO for this purpose if it meets four sets of requirements. The PEO must:[508]

- perform substantial employment functions on behalf of its client employers that adopt the MEP, and maintain adequate records relating to those functions;
- have substantial control over the functions and activities of the MEP, as the plan sponsor (under ERISA §3(16)(B)), the plan administrator (under ERISA §3(16)(A)), and a named fiduciary (under ERISA §402), and continue to have employee benefit plan obligations to MEP participants after the client organization no longer contracts with the organization;[509]
- ensure that each client employer that adopts the MEP acts directly as an employer of at least one employee who is a participant covered under the MEP; and
- ensure that participation in the MEP is available only to employees and former employees of the PEO and client employers, employees and former employees of former client employers who became participants during the contract period between the PEO and former client employers, and their beneficiaries.

The regulation applies a facts and circumstances approach in determining whether a PEO performs substantial employment functions on behalf of its client employers.[510] In addition, the regulation sets forth a safe harbor under which a PEO is considered to perform substantial employment functions on behalf of its client employers that adopt the MEP. According to the DOL, a PEO could satisfy the general facts and circumstances test, even if it does not meet the safe harbor conditions.[511]

The safe harbor criteria must be satisfied with respect to each client-employer employee that participates in the MEP. The safe harbor applies only if the PEO meets all of the following criteria:[512]

- assuming responsibility for and paying wages to employees of its client-employers that adopt the MEP, without regard to the receipt or adequacy of payment from those client employers;
- assuming responsibility for and reporting, withholding, and paying federal employment taxes for its client-employers that adopt the MEP, without regard to the receipt or adequacy of payment from them;
- playing a definite and contractually specified role in recruiting, hiring, and firing workers of its client-employers

479 F. Supp. 2d 1087, 41 EBC 1180 (D. Neb. 2007), rev'd per curiam, 292 Fed. Appx. 519 (8th Cir. 2008) (unpub. op.), *on remand*, 2009 U.S. Dist. LEXIS 9522 (Feb. 9, 2009).

[503] *See* Executive Order 13847, 83 Fed. Reg. 45,321 (Sept. 6, 2018) ("Strengthening Retirement Security in America," directing the DOL to examine policies that would: (1) clarify and expand the circumstances under which employers may sponsor or adopt a multiple employer plan as a workplace retirement savings option for their employees; and (2) expand the access of part-time workers, sole proprietors, working owners, and other entrepreneurial workers with nontraditional employer-employee relationships to workplace retirement savings plans).

[504] 29 C.F.R. §2510.3-55, RIN 1210-AB88, 84 Fed. Reg. 37,508 (July 31, 2019). See the discussion of employee pension benefit plans in 361 T.M., *Reporting and Disclosure Under ERISA*, for the conditions that employer groups or associations must satisfy to have single employer treatment. *See also* RIN 1210-AB92, 84 Fed. Reg. 37,545 (July 31, 2019) (request for information regarding definition of employer under ERISA §3(5)).

[505] 84 Fed. Reg. at 37,510 (preamble to final rule).

[506] 84 Fed. Reg. at 37,518 (preamble to final rule).

[507] 29 C.F.R. §2510.3-55(a) (reference to 29 C.F.R. §2510.3-55(c)). Different criteria apply for a bona fide group or association of employers, which is deemed to be able to act in the interest of an employer within the meaning of ERISA §3(5) if it meets the criteria for (1) a bona fide group or association of employers and (2) commonality of interest (criteria based on the AHP rule). 29 C.F.R. §2510.3-55(a) (reference to 29 C.F.R. §2510.3-55(b)).

[508] 29 C.F.R. §2510.3-55(c)(1).

[509] A MEP offered by a bona fide PEO (or a bona fide group or association) is subject to all of the provisions under ERISA Title I that apply to employee pension benefit plans, and the bona fide PEO assumes and retains responsibility for operating and administering the MEP. Participating employers would retain fiduciary responsibility for choosing and monitoring the arrangement and forwarding required contributions to the MEP. *See* 84 Fed. Reg. at 37,522–24 (preamble to final rule).

[510] 29 C.F.R. §2510.3-55(c)(2).

[511] 84 Fed. Reg. at 37,519 (preamble to final rule).

[512] 29 C.F.R. §2510.3-55(c)(2). The safe harbor is available to both certified PEOs (CPEOs) under I.R.C. §7705(a) and non-CPEOs, and status under the tax code's CPEO provisions is irrelevant to satisfying the safe harbor. *See* 84 Fed. Reg. at 37,519 (preamble to final rule).

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that adopt the MEP, in addition to the client-employer's responsibility for these actions; and

• assuming responsibility for and having substantial control over the functions and activities of any employee benefits which the service contract may require the PEO to provide, without regard to whether those client employers pay for such benefit.

A PEO is deemed to satisfy the third criterion — playing a definite and contractually specified role in these human resources services — if under the contract it (1) actually recruits, hires, and fires, (2) assumes responsibility for these activities, or (3) retains the right or obligation to perform these activities to the extent needed to fulfill its responsibilities under the contract and state law. For example, the PEO client contract could provide that:[513]

• the client-employer's decision to hire an employee does not become official until the PEO approves or ratifies the selection and finishes the administrative on-boarding process; or

• the client employer may not terminate a worksite employee until the PEO validates or approves the termination.

The rule is based on the DOL's short-lived association health plan (AHP) rule, which has been rescinded effective July 1, 2024, but the similarities apply primarily with respect to a bona fide group or association of employers, and not a bona fide PEO. Thus, the rules governing PEO sponsorship of a MEP do not allow for a working owner who does not have common law employees to elect dual treatment as an employer and employee. A working owner's trade or business must have at least one common law employee to participate in a PEO's MEP.[514] Once a working owner who has common law employees joins a PEO's MEP, the working owner may be able to continue under the PEO plan as a former employee if the working owner later must terminate its common law employees. According to the DOL, the working owner in this situation is treated the same as a former employee of a client-employer that has an ongoing contract. The working owner is still a participant covered under the plan with respect to his or her individual account balance because the working owner is or may be eligible to receive a benefit, without regard to whether the contract with the PEO is continued. This status ends when the working-owner-participant is no longer covered by the plan (e.g., he or she receives distributions that represent the balance of his or her credit under the plan, or a plan-to-plan transfer has occurred).[515]

When a participating employer or client employer severs or terminates its relationship with a bona fide PEO (or a bona fide group or association), this action does not extinguish any fiduciary obligations that the PEO owes to these participants as the plan administrator and named fiduciary of the MEP. The fiduciary obligations remain until the participants are no longer covered by the MEP. If the arrangement continues to operate in nearly the same manner as before the severance or termination (e.g., the employer that severed the relationship continues to make contributions) and neither the employer nor the PEO takes action toward a spin-off or transfer within a reasonable time after the severance or termination, the MEP will no longer constitute a single plan for purposes of ERISA. The employer that severed or terminated its relationship with the PEO will be considered to have established and maintained its own separate employee benefit plan. The PEO will be considered to be acting as a service provider to the plan of the former participating employer or client employer. The MEP will continue to constitute a single plan for purposes of title I of ERISA for all remaining non-severed participating employers or client employers.[516]

The DOL regulation includes a severability section so that the ARP rule remains operative to the extent permitted by law if any of its provisions are found to be invalid or are stayed.[517]

C. The Post-Employment Consulting Conundrum

Employees sometimes leave the employ of an employer only to be rehired shortly thereafter as a consultant. This scenario has become more common as the baby boom generation seeks to retire incrementally (e.g., phased retirement) rather than all at once. To work as advertised, the worker must shed employee status based on the *Darden* factors. If the worker that is now referred to as a consultant is still a common law employee, then he or she is misclassified causing a litany of problems and violations detailed at length in III.

To avoid some of these problems, Congress added a provision that allows plans to make working retirement distributions to employees who have reached age 59½ for plan years beginning after December 31, 2019, reduced from age 62 for prior plan years, and have not separated from employment at the time of the distribution.[518] For certain employees in the building and construction industry, the age limitation is lowered to age 55.[519] Final regulations, which were issued before legisla-

[513] 29 C.F.R. §2510.3-55(c)(2)(iii); 84 Fed. Reg. at 37,520 (preamble to final rule).

[514] 84 Fed. Reg. at 37,522 (preamble to final rule). For discussion of the DOL's rescinded association health plan rule, see 395 T.M., *VEBAs and Other Welfare Benefit Funding Arrangements*.

[515] *See* 29 C.F.R. §2510.3-3(d)(2)(ii); 84 Fed. Reg. at 37,522. *See* 29 C.F.R. §2510.3-55(c)(1)(iv) (MEP participation requirement for qualifying as a bona fide PEO).

[516] 84 Fed. Reg. at 37,524–25 (preamble to final rule).

[517] 29 C.F.R. §2510.3-55(e)(1).

[518] §401(a)(36), added by Pub. L. No. 109-280, §905(b), effective for distributions in plan years beginning after 2006, and amended by Pub. L. No. 116-94, Div. M, §104(a) (reducing minimum phased retirement age), effective for plan years beginning after December 31, 2019. Pub. L. No. 109-280, §905(c). ERISA §3(2)(A), as amended by Pub. L. No. 109-280, §905(a), contains a parallel provision. Pub. L. No. 116-94 did not include this age reduction in ERISA §3(2)(A), however. Note that while Pub. L. No. 116-94, Div. M, §104, lowered the age for in-service distributions from age 62 to age 59½, a qualified plan is not required to provide for in-service distributions. If a qualified plan allowed for in-service distributions at age 62 prior to the changes made to §401(a)(36) by Pub. L. No. 116-94, it is not required to be amended to allow for in-service distribution at age 59½ after December 31, 2019. See Notice 2020-68, Q&A F-1.

[519] §401(a)(36)(B), added by the Consolidated Appropriations Act, 2021, Div. EE, Pub. L. No. 116-260, §208, effective for distributions made before, on, or after December 27, 2020. The 55 year age limitation applies in the case of multiemployer pension plans described in ERISA §4203(b)(1)(B)(i) with respect to individuals who were participants in such a plan on or before April 30, 2013 if: (a) the plan trust was in existence before January 1, 1970, and (b) before December 31, 2011, at a time when the plan provided that distributions could be made to an employee who had attained age 55 and who was not separated from employment at the time of such distribution, the plan received at least one written determination from the IRS that the trust constituted a qualified trust under §401(a)(36).

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tion reduced the minimum age for working retirement distributions, amend Reg. §1.401(a)-1 to incorporate §401(a)(36) that permits pension plans to make an in-service distribution beginning at age 62 and to adopt the previous administrative guidance that permitted in-service distributions from pension plans upon attainment of the plan's normal retirement age. In addition, rules regarding the establishment of a normal retirement age were issued.[520] The IRS is considering additional guidance under §401(a)(36) to facilitate phased retirement programs.[521]

If a worker who is not participating in a bona fide phased retirement program transfers to consulting status and receives a distribution from the employer's tax-qualified retirement plans, then questions arise with respect to the plans' ability to provide in-service distributions. In-service distributions from a defined benefit pension plan or money purchase plan generally result in disqualification unless the distributions are made at the earlier of age 62 or the plan's normal retirement age.[522] Distributions cannot be made solely as a result of a reduction in the number of hours an employee works.[523] If the individual was a participant in and made elective deferrals under the employer's §401(k) plan, and if he or she transfers to consulting status prior to attaining age 59½ and takes a distribution of such deferrals, then the requirements of §401(k)(2)(B)(i) will be violated and the cash-or-deferred feature is disqualified.

With perhaps the exception of retiree medical coverage, the newly minted consultant often ceases participation in the employer's pension, welfare and fringe benefit plans. Where the underlying plan provisions designate all of the employees of the employer as participants, the worker may have a claim under ERISA in the case of pension or welfare benefit plans, or under state law in the case of other fringe benefit plans for benefits that have been wrongfully denied. Moreover, depending on the facts, the worker also may state a claim under ERISA §404 for breach of fiduciary duty or ERISA §510 for improper exclusion.[524]

D. The Accidental Multiple-Employer Welfare Arrangement

A MEWA is an employee welfare benefit plan, or any other arrangement which is established or maintained for the purpose of offering or providing medical or other welfare benefits to the employees of two or more employers.[525] By definition, a MEWA must include two or more employers. Under ERISA §3(40)(B)(i), the employers must not be part of the same control group of trades or businesses. The determination of what constitutes a control group is made by applying principles similar to those in §414(c). Although the statute permits the DOL to lower the control group percentage thresholds prescribed by Reg. §1.414(c)-2[526] to 25% from 80% (for parent-subsidiary control groups) and to 50% from 80% (for brother-sister control groups), the only such regulation that lowers the threshold applies only for reporting purposes.[527]

The growth of the contingent workforce has given rise to a renewed interest in MEWAs for at least two reasons. On the positive side, some contingent workers tend to have less access to welfare benefits than their traditionally employed counterparts. A properly structured MEWA could give such workers the ability to purchase welfare benefit coverage at reasonable prices. The MEWA rules furnish the legal basis for the collective purchase of employment-based welfare benefits. The downside, however, is when an employer covers its contingent workers under its health care plan and it is later determined that the workers are common law employees of the staffing agency from which the workers were retained. Where this occurs, the employer's plan provides welfare benefits to employees of two unrelated employers — i.e., a MEWA that is subject to regulation as such.

ERISA covers only those plans, funds or arrangements that constitute an employee welfare benefit plan[528] or an employee pension benefit plan.[529] As noted above, MEWAs provide welfare benefits, so only MEWAs that constitute welfare plans are subject to regulation under ERISA. Much of the early skirmishing over the ability of states to regulate MEWAs turned on the issue of whether a MEWA was *itself* a welfare plan in addition to offering welfare benefits. Prior to 1983, if a MEWA was itself a welfare plan, then state regulation was precluded by reason of the ERISA preemption rules. On the other hand, if a MEWA was not itself a welfare benefit plan, then ERISA's preemptions did not apply, and the state was free to regulate the MEWA in accordance with applicable state law.

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[520] T.D. 9325, 72 Fed. Reg. 28,604–28,607 (May 22, 2007); Reg. §1.401(a)-1(b)(2). If a qualified plan lowers its minimum age for in-service distributions to age 59½ as result of the changes made to §401(a)(36) by Pub. L. No. 116-94, Div. M, §104(a), it cannot change its definition of normal retirement age to age 59½ unless age 59½ is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. Generally, a normal retirement age of age 62 or later is deemed to satisfy the reasonably representative requirement pursuant to Reg. §1.401(a)-1(b)(2)(ii). See Notice 2020-68, Q&A F-2.

[521] Notice 2007-8.

[522] Reg. §1.401(a)-1(b)(2).

[523] Reg. §1.401(a)-1(b)(3).

[524] *See, e.g.*, *Seaman v. Arvida Realty Sales*, 985 F.2d 543, 16 EBC 1689 (11th Cir. 1993) (holding that employee who was terminated for refusing to accept change in status to independent contractor with corresponding loss of employer-provided benefits stated a valid claim under ERISA §510 for interference with ERISA-protected rights).

[525] ERISA §3(40). Specifically excluded from the definition of a MEWA under ERISA §3(40)(A) are arrangements established or maintained "(i) under or pursuant to one or more agreements which the Secretary finds to be collective bargaining agreements, (ii) by a rural electric cooperative, or (iii) by a rural telephone cooperative association." For rules for determining whether an employee welfare benefit plan is collectively bargained, see 29 C.F.R. §2510.3-40. For rules on administrative hearing procedures to obtain a determination by the DOL as to whether a particular plan is collectively bargained, see 29 C.F.R. §2570.150. *See also* EBSA Information Letter to Nicholas W. Ferrigno Jr. (May 24, 2004) (status as an affiliated service group under I.R.C. §414(m) does not, in and of itself, support a conclusion that a group of two or more businesses are a single employer for purposes of ERISA §3(40); status under I.R.C. §414(m) may be based upon an interest of less than 25%).

[526] *See* ERISA §3(40)(B)(iii). Note that for certain MEWA reporting purposes discussed below, the DOL's position is that reporting is not required if an entity would not constitute a MEWA but for the fact that it provides coverage to the employees of two or more trades or businesses that share a common control interest of at least 25% at any time during the plan year (applying the principles under §414(b) or §414(c)). The DOL noted that while use of a 25% test may result in a determination of common control for MEWA reporting purposes, common control generally means, under §414(b) and §414(c), an 80% interest in the case of a parent subsidiary group, and a more-than-50% interest in the case of a brother/sister relationship among organizations controlled by five or fewer persons with respect to each organization. *See* 68 Fed. Reg. at 17,496 (Apr. 9, 2003).

[527] 29 C.F.R. §2520.101-2(c)(2)(ii)(A) (discussed below).

[528] ERISA §3(1).

[529] ERISA §3(2).

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Legislation enacted in 1983[530] largely eliminated the need to decide whether a MEWA is an employee welfare plan for purposes of state regulation, but the distinction still has some residual viability.[531]

The reporting and disclosure obligations of a MEWA turn in large part on whether the MEWA is itself a welfare benefit plan. If so, then the MEWA must file a single annual report (Form 5500).[532] If the MEWA is not itself a welfare plan, then each employer that participates in the plan will need to file its own annual report. The DOL has provided for a regulatory exemption for group insurance arrangements under which a single annual report is filed and participating employers need not file individual annual reports.[533] An arrangement is a group insurance arrangement if it (i) provides benefits to the employees of two or more unaffiliated employers, but not in connection with a multi-employer plan, or (ii) fully insures one or more welfare plans of each participating employer through insurance contracts purchased solely by the employers or purchased partly by the employers and partly by their participating employees, with all benefit payments made by the insurance company. The contributions by participating employees must be forwarded by the employers within three months of receipt, refunds for contributing participants must be returned to them within three months of receipt, upon entry into the plan contributing participants must be informed of the plan provisions concerning the allocation of refunds, and the arrangement must use a trust (or other entity such as a trade association) to hold the insurance contracts and pay premiums to the insurance company.[534]

The Secretary of Labor is authorized to assess a civil penalty of up to $1,000 a day (as adjusted for inflation) per plan for annual reports that are filed late.[535] However, the DOL has set penalties substantially lower by administrative announcement: late filers may be penalized $50 a day per plan; nonfilers may be penalized $300 a day per plan, up to $30,000 a year per plan.[536] Further, the per-day penalty amount is reduced to $10 for late filers that voluntarily comply under the DOL's Delinquent Filer Voluntary Compliance (DFVC) program.[537] In the case of a single late annual report filing for a plan, the DFVC program caps the cumulative daily penalty for a plan year at $750 for small plans and $2,000 for large plans. The annual report penalties for a plan that has filing delinquencies for multiple plan years is capped at $1,500 for small plans and $4,000 for large plans. If a plan files without paying the DFVC penalties, the penalties ultimately imposed likely are to be much greater. The IRS also provided late filing penalty relief in Notice 2014-35[538] for filers who meet the requirements of the DFVC program. Relief will be granted once the late filer satisfies the requirements of the DFVC program, including paying the reduced penalties under ERISA §502(c)(2) and filing with the IRS by mail any required Form 8955-SSA within 30 days after the filer completes the DFVC filing.[539]

Administrators of MEWAs are required to file Form M-1 (Annual Reporting Requirement for Multiple Employer Welfare Arrangements and Certain Entities Claiming Exception (ECEs)) to determine compliance with Part 7 of ERISA (relating to group health plan requirements).[540] A Form M-1 must be filed annually by a MEWA that offers or provides medical care benefits, regardless of whether the entity is a group health plan under ERISA. The rule also applies to arrangements that would be MEWAs but for the fact that they are established or maintained pursuant to a collective bargaining agreement. ECEs also are required to file annually only for the first three years following startup or "origination."

In addition to federally mandated filing requirements, state statutes that regulate MEWAs almost universally impose their own filing requirements.

The ERISA reporting requirements are particularly troublesome in the case of an "accidental" MEWA. As the name implies, an accidental MEWA arises in situations where the plan sponsor neither intends, nor even knows, that its actions have resulted in the establishment of a MEWA. Accidental MEWAs are most common in the following instances:

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[530] *See* §302(b) of Pub. L. No. 97-473 (1983).

[531] See, for example, DOL Adv. Op. 2007-05A, in which the DOL advised that whether an arrangement is a MEWA within the meaning of ERISA §3(40) is a question of federal law, and thus, a state statute addressing an employee leasing company's relationship to leased employees would not govern the determination of whether any particular benefit arrangement sponsored by the employee leasing company is a MEWA for purposes of ERISA. Whether a plan is a single-employer plan for ERISA purposes is also a question of federal law. Further, to the extent that a state law purports to govern the determination of whether a particular arrangement is a MEWA for ERISA purposes, it is preempted by ERISA §514. Although ERISA §514(b)(6) allows state insurance regulation of employee benefit plans that are MEWAs, subject to certain limits, it does not require states to do so; a state may decide not to regulate MEWAs to the full extent permitted under ERISA. *Id.* Where the MEWA is not itself a welfare benefit plan, then each employer that participates in the MEWA will be deemed to maintain its own, separate welfare plan. Each employer therefore will have to separately satisfy the annual reporting requirements under ERISA §103. If, on the other hand, the MEWA is itself a welfare benefit plan, then only a single, plan-wide annual report is required.

[532] ERISA §104. An administrative exemption excuses certain insured or unfunded welfare benefit plans with fewer than 100 participants from the Form 5500 filing requirement. However, beginning with the 2013 Form 5500 filing, the limited filing exemption is not available to plan MEWAs that must file the Form M-1. 29 C.F.R. §2520.104-20(b), as amended at RIN 1210-AB51, 78 Fed. Reg. 13,781 (Mar. 1, 2013).

[533] 29 C.F.R. §2520.104-43, §2520.103-2, §2520.103-3.

[534] 29 C.F.R. §2520.104-21(b).

[535] ERISA §502(c)(2); 29 C.F.R. §2575.3. For a table of the current and prior DOL penalties imposed on an ERISA plan, see the Worksheets in 361 T.M., *Reporting and Disclosure Under ERISA*.

[536] DOL News Release 92-158 (Mar. 23, 1992).

[537] *See* DOL Delinquent Filer Voluntary Compliance Program, RIN 1210-ZA15, 78 Fed. Reg. 6135 (Jan. 29, 2013), updating and restating RIN 1210-AA86, 67 Fed. Reg. 15,052 (Mar. 28, 2002). For further discussion of the DFVC program, see 365 T.M., *ERISA — Fiduciary Responsibility and Prohibited Transactions*.

[538] Superseding Notice 2002-23.

[539] For DFVC filings submitted after 2009 (i.e., through EFAST2) and before issuance of the Notice 2014-35 relief, filers had to mail the Form 8955-SSA by the later of 30 days after completion of the DFVC filing or December 31, 2014. *See* Notice 2014-35.

[540] *See* 29 C.F.R. §2520.101-2. If a filing is required, it is due on or before each March 1 following the period to be reported. A 90-day report is also required to be filed as described in 29 C.F.R. §2520.101-2(e)(2)(ii). Failure to file the Form M-1 can result in a civil penalty of up to $1,000 per day (as adjusted for inflation). ERISA §502(c)(5); 29 C.F.R. §2560.502c-5, 29 C.F.R. §2575.3. For a table of the current and prior DOL penalties imposed on an ERISA plan, see the Worksheets in 361 T.M., *Reporting and Disclosure Under ERISA*. Beginning with the 2013 Form 5500 filing, administrators of plans that are subject to the M-1 filing requirement must complete Form M-1 compliance questions contained in the Form 5500. 29 C.F.R. §2520.103-1(f), added at RIN 1210-AB51, 78 Fed. Reg. 13,781 (Mar. 1, 2013). For further discussion of these reporting requirements, see 361 T.M., *Reporting and Disclosure Under ERISA*.

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• When an employer hires workers from a staffing agency or leasing firm but covers them under its medical plan, and if the employees are determined to be common law employees of the leasing company or staffing firm, but not the employer, then the plan is a MEWA because it covers the employees of two or more employers.[541]

• PEOs routinely claim to be the co-employer of workers placed with client companies. PEOs often furnish welfare benefits to these co-employees. But ERISA does not recognize any doctrine of co-employment. If sufficient control and other indicia of employee status are with the recipient company, then the workers may be common law employees of the recipient and not the PEO.[542] If so, the PEO's medical plan may be an accidental MEWA because it furnishes benefits to employees of more than one employer.

• When an employer engages in a corporate transaction, such as the spin-off of a division, that results in there being two or more control groups, its group health plan will inadvertently become a MEWA if all of the company's employees continue to be covered. The same problem can arise where an employer enters into a joint venture, and for the sake of expediency, decides to expand coverage under its group health plan to the employees of the joint venture. To address such situations, DOL rules excuse employers from having to file a Form M-1 in the following situations: (1) a group health plan covering employees of two or more employers will be deemed to be a part of the same control group of corporations (and therefore is not a MEWA) when the level of common control is at least 25% instead of the 80% described in I.R.C. §414; (2) following a change in control of businesses (such as a merger or acquisition), the entity provides to the employees of two or more employers coverage that is temporary in nature (i.e., the coverage does not extend beyond the end of the plan year following the plan year in which the change in control occurs); and (3) a group health plan covers only a small number of individuals (less than 1% of the total number of plan participants) who are not employees of the plan sponsor.[543]

E. Employees of Partnerships and LLCs

Where business is conducted in the corporate form, worker classification issues are governed almost exclusively with reference to the *Darden* factors. A worker is either an independent contractor or an employee. Ownership is not generally an issue except when applying certain tax-related, nondiscrimination requirements. But where self-employed individuals are concerned, the inquiry takes on an additional layer of complexity. Ownership is now an issue. Whether an individual is an owner, an employee or both has consequences for employment tax and income tax withholding purposes as well as in connection with the administration of employee and fringe benefit plans. Self-employed individuals are treated as their own employees for most tax-qualified retirement plan purposes. So misclassification of a self-employed individual as an employee, say, is not necessarily fatal. Self-employed individuals, however, are not generally eligible to participate in, or at least reap the tax advantages of, tax-favored fringe benefit plans. And in the case of a §125 cafeteria plan, including a single self-employed individual disqualifies the arrangement as to all participants.

The worker classification issues described in III. and IV. and the fiduciary and other issues covered in VII. generally apply irrespective of the underlying organization of the plan sponsor. Workers can be employed by, and be the common law employees of, sole proprietorships, partnerships, LLCs and corporations alike. But there are some important differences in the manner in which employee benefits are protected and taxed depending on the form of the plan sponsor.

1. Employment Status of LLC Members

It is not uncommon for a partner or LLC member to contribute both capital and services to a partnership or LLC, as the case may be. Where this occurs, only distributions based on services should be treated and taxed as self-employment income (returns of capital should not). The challenge is to distinguish between the two. The stakes differ somewhat based on the amount of capital involved. A partnership or LLC that provides primarily personal services and that has only a modest capital base will not be too concerned if the sorting mechanism is imperfect, but where the person rendering services also receives a significant return of capital, the proper apportionment of these items matters a great deal. While these issues are fairly well established where partnerships are concerned, they remain largely unexplored in the LLC context.

Under §1402(a), a general partner is treated as self-employed and as having self-employment income with respect to his or her distributive share of partnership income. The definition of a self-employed individual contained in §401(c)(1)(B) is an individual who has earned income (as defined and described in §401(c)(2)) for the taxable year, and is consistent with the IRS's treatment of partners as independent contractors.[544] But under §1402(a)(13) the distributive share of partnership income to a limited partner is not treated as self-employment income unless the distribution is a guaranteed payment

[541] *See* Rev. Rul. 75-41 (finding that workers provided to recipient through staffing firm were common law employees of staffing firm and not the recipient).

[542] *Contingent Workforce: Be Prepared to Cede Control Over Temps, Independent Contractors*, 27 Pens. & Ben. Rep. 1377 (2000).

[543] *See* 29 C.F.R. §2520.101-2(c)(2)(ii)(A) through §2520.101-2(c)(2)(ii)(C).

[544] *See, e.g.*, Rev. Rul. 69-184 (partners who devote their time and energies to conduct of trade or business of partnership, or in providing services to partnership are independent contractors and not individuals who, under usual common law rules applicable in determining the employer-employee relationship, have employee status; they are not employees of partnership for employment tax and income tax withholding). For self-employment tax purposes, a disregarded entity owned by a partnership is not treated as a separate entity from the partnership; thus, amounts paid to partner "employees" of the disregarded entity are taxed on self-employment income. Reg. §301.7701-2(c)(2)(iv)(C)(2), added by T.D. 9869, 84 Fed. Reg. 31,478 (July 2, 2019). This treatment of disregarded entities applies as of the later of August 1, 2016, or the first day of the latest-starting plan year following May 4, 2016, of a qualified plan, a health plan or a cafeteria plan that benefits participants whose employment status is affected and that is sponsored by the disregarded entity. Reg. §301.7701-2(e)(8), added by T.D. 9869. The rule does not address the application of Rev. Rul. 69-184 in tiered partnership situations.

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within the meaning of §707(c).[545] Limited partners, therefore, are not generally treated as receiving self-employment income.

According to the IRS, for purposes of determining net earnings from self-employment, a partnership is one that is recognized as a partnership for income tax purposes. Therefore, if an LLC is taxed as a partnership, then the LLC members will be treated as partners, and any distributive share of LLC income or loss is includible in net earnings from self-employment.[546] But the §1402(a)(13) exception under which the distributive share of a limited partner is not treated as self-employment income refers only to partnerships, not to LLCs. So it is not clear whether this exception is available in the case of an LLC. In an effort to offer some certainty in the matter, the IRS issued proposed regulations.

Under former Prop. Reg. §1.1401(a)-18, a member's distributive share of non-excludible LLC income would be income from self-employment unless the member qualifies for the limited partner exception. Under the exception, a member would be treated as a limited partner if (1) the member is not a manager, and (2) pursuant to the statutes under which the LLC was formed, the entity could have been formed as a limited partnership and the member could have qualified as a limited partner. For this exception to apply, however, there would have to be at least one manager of the LLC. The apparent intent of this proposed rule was to ensure that non-manager LLC members who performed substantial services for the LLC would be treated as general partners. But if under local law the LLC member could perform substantial services and not be subject to unlimited liability, he or she might have still qualified for the limited partner exception as described in this regulation.

Another proposed regulation was issued in 1997 and was intended to fill some of the gaps in an earlier proposal by classifying general and limited partners on the basis of functional tests rather than state law definitions. The regulation would have established three categories. Under the first, an individual automatically would be a limited partner unless he or she (1) has personable liability for the LLCs debts, (2) has authority to contract on behalf of the LLC, or (3) participates in the trade or business for more than 500 hours in a year. Under the second category, an individual who was treated as a general partner under the first category could nonetheless be classified as a limited partner with respect to another class of LLC interest if other criteria were met. The last category made some further refinements that would have provided relief to certain individuals who worked more than 500 hours in the trade or business of the LLC but did not have some of the other indicia of general partnership.[547]

This set of rules raised the ire of Congress.[548] In §935 of the Taxpayer Relief Act of 1997 ("TRA '97"),[549] Congress provided that no temporary or final regulation with respect to the definition of a "limited partner" under §1402(a)(13) could be issued or made effective before July 1, 1998. Despite the lapse of the moratorium, the IRS has issued no further regulations on this issue.

Until this issue is clarified, whether a member of an LLC's distributive share is subject to the self-employment income tax remains uncertain. Under current law, there is no mechanism that permits the bifurcation of an LLC member's interest to distinguish between compensation for services and return of capital. This leads to the strange result that an individual who might otherwise clearly be an employee of an LLC when tested under the *Darden* factors is treated as self-employed simply by reason of holding even a nominal membership interest in the LLC for which he or she performs services.

The employment tax consequences of being classified as an employee or a self-employed individual differ substantially. While contributions to a qualified plan on behalf of an employee reduce their wages for employment tax and withholding purposes, such contributions do not reduce Self Employment Contributions Act income.[550] Under Reg. §31.3121(a)(1)-1(a)(3), an employer generally may not take into account that an employee has other FICA wages for the year. Where FICA taxes are over withheld as a result, the employee (but not the employer) can apply for a refund.[551] To this general rule there is an exception in the case of affiliated employers that use a "common paymaster."[552] Under the common paymaster rule, for FICA tax purposes, if two or more related corporations concurrently employ the same individual and compensate him or her through a common paymaster, then each such corporation is considered to have paid as remuneration only the amounts actually disbursed by it to the individual. As a result, the total amount of the employee and employer tax is determined as though the individual had only one employer. The common paymaster rule is, however, limited to corporations; it is not available to partnerships and LLCs.

2. *Tax-Qualified Plans and Cash or Deferred Arrangements*

Sole proprietors, partners and LLC members may be covered under tax-qualified retirement plans maintained by their proprietorship, partnership or LLC, as the case may be. Section 402(c)(1) treats these self-employed individuals as employees for qualified plan purposes. As noted above, the distinguishing feature of a self-employed individual is that he or she has earned income within the meaning of §401(c)(2). Under §401(c)(2)(A), earned income is defined as net earnings from self-employment (as defined and described in §1402(a)) with

[545] The distributive share of a limited partner's income is not self-employment income. If the same person has both a general and limited partnership interest, then his or her partnership income is bifurcated for self-employment tax purposes under §1402(a)(13). Bifurcation in the case of LLC interests was permitted under Prop. Reg. §1.1402(a)-2(h)(3). That proposed regulation was suspended by §935 of the TRA '97 through July 1, 1998.

[546] *See* PLR 9432018 (determining that distributive shares of members actively engaged in business of LLC were included in net income for self-employment tax purposes).

[547] Former Prop. Reg. §1402-2(h)(2).

[548] Under a "Sense of the Senate" provision in the Senate-passed version of TRA '97 (H.R. 2014, §734), the Senate expressed its concern that the proposed rule exceeded the IRS's regulatory authority and would effectively change the law without congressional action.

[549] Pub. L. No. 105-34.

[550] §1402(a).

[551] §6413(b); Reg. §31.6413(c)-1.

[552] §3121(s). Although generally limited to corporations, the common paymaster rule applies to a state university that employs health care professionals as faculty members at a medical school and a tax-exempt faculty practice plan (which may be organized as an LLC) so long as 30% or more of the employees of the practice plan currently are employed by the medical school. *See* PLR 201003010, PLR 200944016, PLR 200312012; TAM 9802001.

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certain modifications.[553] Section 401(c)(2)(A)(i) expressly limits earned income to income from a trade or business in which personal services of the taxpayer are a material income-producing factor. Under §404(a)(8), no deduction is permitted for contributions to a tax-qualified plan on behalf of a self-employed individual in excess of earned income.

Because earned income is, essentially, gross income less deductions, the deduction for contributions to a tax qualified plan on behalf of a self-employed individual reduces earned income.[554] This results in certain modifications to both the applicable contribution and deduction limits. Section 404(a)(3) limits an employer's deduction for qualified plan contributions with respect to any plan year to 25% of covered compensation.[555] But because amounts contributed on behalf of self-employed individuals reduce their earned income dollar-for-dollar, the determination of the maximum amount of the deductible contribution requires the application of an algebraic formula.[556] Additionally, under §404(e), contributions allocable to the purchase of life, health, or other insurance for self-employed individuals shall not be taken into account in applying the limits of §404(a)(1), §404(a)(2) and §404(a)(3).

There also are special rules for owner-employees. An owner-employee is defined in §401(c)(3) to mean an employee who owns the entire interest in an unincorporated trade or business, or in the case of a partnership, is a partner who owns more than 10% of either the capital interest or the profits interest in the partnership. Although, not explicitly stated, an LLC member who owns more than 10% of the capital or profits probably is an owner-employee. I.R.C. §4975(f)(6) and ERISA §408(d)(1) both allow plan loans to be made to owner-employees without engaging in a prohibited transaction. Thus, owners of unincorporated businesses, partners who own more than 10% of a partnership's capital or profit interest (and, by extension, LLC members), and S corporation shareholders are eligible to participate in a plan loan program. This exception does not extend to owners of individual retirement accounts.

Matching contributions made on behalf of a self-employed individual (including a partner) are not treated as elective employer contributions.[557] However, matching contributions are treated as subject to the ACP discrimination test.

3. *Welfare and Fringe Benefits*

For the reasons discussed at length in III.E.2., self-employed individuals cannot exclude the value of employer-provided health insurance from income under §105 and §106. But they are able to deduct the amounts that they pay for coverage under §162(l)(1).[558] Although self-employed individuals are not generally eligible for the tax benefits conferred on employees under the rules governing fringe benefit plans, there are a handful of fringe benefits that are available to them. These include dependent care assistance under §129 (unless furnished though a cafeteria plan), no-additional-cost-services and employee discounts under §132(c), working condition fringe benefits under §132(d) and de minimis fringe benefits under §132(e). Accident and health insurance premiums paid by a partnership on behalf of a partner without regard to partnership income for services rendered in his or her capacity as a partner are guaranteed payments under §707(c). Accident and health insurance premiums paid by an S corporation on behalf of a 2% shareholder-employee as consideration for services rendered also are treated as guaranteed payments. Such payments are deductible by the partnership or corporation under §162, includible in the recipient-partner or shareholder-employee's gross income under §61 and deductible by the individual under §162(l)(1).

4. *ERISA*

ERISA §3(6) defines the term "employee" to mean any individual employed by an employer and ERISA §3(7) defines the term "participant" to mean any employee or former employee of an employer who is or may become eligible to receive a benefit of any type from an employee benefit plan. But what if the same individual, i.e., a self-employed individual, is both the employer and an employee? Does the self-employed individual get the benefit of the protections provided by ERISA to employees? If a plan covers only a self-employed individual or a self-employed individual and his or her spouse, the answer is found in 29 C.F.R. §2510.3-3(c)(1), which provides that an individual and his or her spouse shall not be deemed to be employees with respect to a trade or business, whether incorporated or unincorporated, which is wholly owned by the individual or by the individual and his or her spouse.

If the plan covers self-employed individuals and common law employees, the answer was less clear until the U.S. Supreme Court resolved a split among several federal appeals courts in *Raymond B. Yates, M.D., P.C. Profit Sharing Plan v. Hendon*.[559] The Court clarified that so long as an ERISA-covered pension plan, established and maintained by the working owner of a business (e.g., a 100% shareholder of a Subchapter S corporation), also covered common law employees other

[553] Section 401(c)(2) (defining "earned income" as "net earnings from self-employment" (as defined in §1402(a)), except that such earnings are to be determined: (i) only with respect to a trade or business in which the taxpayer's personal services are a material income-producing factor; (ii) without regard to §1402(c)(4) and §1402(c)(5) (relating to services performed by a duly ordained minister or Christian Science practitioner, respectively); (iii) in the case of an individual who is treated as an employee under §3121(d)(3)(A), §3121(d)(3)(C), or §3121(d)(3)(D) (relating to certain agent-drivers or commission-drivers, home workers and traveling salespersons, respectively), without regard to §1402(c)(2) (which provides special rules relating to the definition what types of services constitute a "trade or business" for purposes of determining self-employment income); (iv) without regard to items not included in gross income for purposes of Chapter 1 of the I.R.C. and the deductions properly allocable or chargeable against such items; (v) without regard to the qualified plan deduction allowed under §404 to the taxpayer; and (vi) with regard to the deductions allowed by §164(f) (relating to the deductibility of self-employment taxes for income tax purposes)).

[554] §401(c)(2)(A)(v) and §404(a)(8).

[555] §404(a)(3)(A)(i)(I).

[556] *See* Griesemer and Winn, *Qualified Plan Contributions for the Self-Employed — the Mathematics of Parity*, 19 Tax Mgmt. Compensation Plan. J. 215 (1991) (describing the particulars of this calculation which effectively reduces the limit to 20% for self-employed persons).

[557] §408(p)(9) and §402(g)(8); Reg. §1.401(k)-1(a)(6)(ii).

[558] As amended by Pub. L. No. 111-152, §1004(d)(2), effective March 30, 2010 (expanding deduction to cover amounts paid to insure any child (as defined in §152(f)(1)) of the taxpayer who was under age 27 at the end of the taxable year). Prior to 2003, self-employed individuals were permitted to deduct only a percentage of health care costs, as follows: 1999 through 2001, 60%; 2002, 70%; and 2003 and thereafter, 100%. *See* former §162(l)(1)(B), prior to amendment by Pub. L. No. 111-152.

[559] 514 U.S. 1, 32 EBC 1097 (2004).

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than the owner and his spouse, the owner is considered a participant under the plan and, thus, is entitled to the same ERISA protections afforded all plan participants. Therefore, in *Yates*, the sole shareholder and president of a business qualified as a participant in an ERISA-covered pension plan. The Court relied on DOL Adv. Op. 99-04A, which advised that the statutory term "employee benefit plan" does not include a plan with only the owner and his or her spouse as participants but does include a plan that covers one or more common law employees in addition to the self-employed individuals. The Advisory Opinion relied on 29 C.F.R. §2510.3-3, which provides that plans that cover only sole owners or partners and their spouses fall outside of ERISA's protections, while plans that cover working owners and their non-owner employees fall entirely within ERISA's purview. Compare DOL Adv. Op. 2020-01A, in which the DOL advised that limited partnership health benefit programs offered to "limited partners" by data mining partnerships, which produce and sell to third party purchasers the electronic data of their "limited partners," are not employee welfare benefit plans under ERISA, and the limited partners are not participants in single-employer self-insured group health plans. The DOL noted that the agreements signed by these individuals do not require them to work for or through the partnership and they do not receive income for performing services for or as partners. A district court disagreed and enjoined the DOL from refusing to acknowledge the ERISA status of the plan and from refusing to recognize the limited partners as working owners of the limited partnerships in issue. The court relied on *Yates* and DOL Adv. Op. 99-04A in deciding that DOL Adv. Op. 2020-01A is arbitrary and capricious under the Administrative Procedure Act and contrary to law under ERISA. The court determined that the limited partners are working owners and bona fide partners; thus, if at least one common law employee is covered, they may participate in the plan.[560] The Fifth Circuit upheld the vacatur of DOL Adv. Op. 2020-01A. The court vacated the injunction, however, and remanded the case for the district court to consider whether the working owners in question qualify as plan participants under *Yates* and whether the limited partners are bona fide partners under 29 C.F.R. §2590.732(d)(2).[561]

Under a short-lived "association health plan" (AHP) regulation issued in 2018 that allowed a group of employers or an association to elect to act as a single "employer" under ERISA §3(5) to establish a plan that is an employee welfare benefit plan and a group health plan under ERISA, a sole proprietor or partner who met the requirements to be a working owner of a trade or business could have dual status as an employer and employee for purposes of determining whether a bona fide group or association of employers exists to establish a group health plan.[562] The rescinded rule also relaxed the requirements for the employer members to have a commonality of interest and included nondiscrimination requirements for qualifying under this alternative. However, after a court vacated the working owner and commonality provisions in 2019 and the DOL, under a different presidential administration, reconsidered the rule, the DOL concluded that those portions of the rule were not sufficient to distinguish between meaningful employment-based relationships, as contemplated by ERISA, and commercial insurance-type arrangements. For further discussion of association health plans, see 395 T.M., *VEBAs and Other Welfare Benefit Funding Arrangements*.

If the ERISA protections are not available to self-employed individuals, there remains the question of whether that individual's state law remedies are preempted by ERISA. In one case, the First Circuit did not seem troubled by the lack of a remedy, although it remanded the matter to the district court rather than make the determination.[563] A few courts have allowed claims to proceed under ERISA by finding that self-employed individuals have standing as beneficiaries.[564] The more common view is that, even if there are no ERISA remedies available to self-employed individuals, their state law remedies are not impaired.[565] *Madden v. Country Life Ins. Co.*[566] involved a partner in a law firm that sponsored a group health and hospitalization policy covering the two partners and their single employee. At issue was whether the partner's claim was governed by ERISA. The court held that the plaintiff did not qualify as a participant under ERISA and was not eligible to invoke the remedies of ERISA §502(a). Because he was not entitled to bring an ERISA claim, the court held that his state law claims were not preempted and, as a result, remanded the case back to state court. The question of whether state law applies is a matter of some importance because state law remedies, if available, may be more generous than those afforded under ERISA. Separately, where benefits under group health care plans are concerned, the Health Insurance Portability and Accountability Act of 1996 made it clear that self-employed individuals are participants covered by ERISA.[567]

But claimants do not always prefer their state law remedies. *Simpson v. Ernst & Young*[568] involved a claim by a partner in a large accounting firm for, among other things, the protections afforded by ERISA with respect to three partnership-sponsored retirement plans. Shortly after the 1989 merger of two of the world's largest accounting firms — Ernst & Whinney and Arthur Young (to form Ernst & Young) — Simpson, a partner in the firm's Cincinnati office, was terminated. At

[560] *Data Mktg. P'ship, LP v. DOL*, 490 F. Supp. 3d 1048 (N.D. Tex. 2020), aff'd in part, vacated in part, 45 F.4th 846 (5th Cir. 2022).

[561] *Data Mktg. P'ship, LP v. DOL*, 45 F.4th 846 (5th Cir. 2022).

[562] *See* RIN 1210-AC16, 89 Fed. Reg. 34,106 (Apr. 30, 2024), effective July 1, 2024 (rescinding 29 C.F.R. §2510.3-5, association health plan (AHP) rule finalized in RIN 1210-AB85, 83 Fed. Reg. 28,912 (June 21, 2018)). *See also New York v. DOL*, 363 F. Supp. 3d 109 (D.D.C. 2019) (vacating portions of 29 C.F.R. §2510.3-5); *Till v. Nat'l Gen. Accident & Health Ins. Co.*, No. 21 C 1256, 2022 BL 77400 (N.D. Ill. Mar. 8, 2022) (individual policy bought through association of employers is not covered by ERISA; 29 C.F.R. §2510.3-5(b) interpretation of ERISA §3(5) is unreasonable).

[563] *Kwatcher v. Massachusetts Service Employees Pension Fund*, 879 F.2d 957, 11 EBC 1682 (1st Cir. 1989).

[564] *Harper v. Am. Chambers Life Ins. Co.*, 898 F.2d 1432, 12 EBC 1238 (9th Cir. 1990) (finding ERISA plan participants and beneficiaries must have recourse to civil enforcement of ERISA plan provisions in order to further the statute's purpose of promoting ERISA plan integrity).

[565] *Kelly v. Blue Cross & Blue Shield of R.I.*, 814 F. Supp. 220, 16 EBC 1809 (D.R.I. 1993) (refusing to "strip persons who fail to qualify as participants or beneficiaries of the right to sue for recovery arising out of a clearly established contractual relationship"); *Dodd v. John Hancock Mut. Life Ins. Co.*, 688 F. Supp. 564, 571 (E.D. Cal. 1988) (owner was participant in health plan because plan covered owner and employees; state law claims were preempted by ERISA).

[566] 835 F. Supp. 1081 (N.D. Ill. 1993).

[567] ERISA §732(d).

[568] 100 F.3d 436, 20 EBC 2088 (6th Cir. 1996).

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the time of the merger, the combined firms had a projected unfunded retirement obligation exceeding $290 million. Simpson alleged that, by eliminating older partners before their interest in this pension vested, the newly formed firm could avoid substantial unfunded accrued retirement liabilities. Three of the plans in question were intended to cover only partners. As such, they were not subject to ERISA's vesting standards.[569] Simpson could therefore be divested of his pension rights in connection with his termination. But if Simpson was an employee, he would be entitled to the benefit of the ERISA vesting rules and his pension benefit would be secure. Simpson claimed that, though nominally a partner, he was an employee for purposes of ERISA, the ADEA, and an Ohio anti-discrimination statute. Although Simpson was party to a partnership agreement, the court found that he had few if any of the indicia of partnership. While he had the right to vote on amendments to the partnership agreement, among other things, he had no say in hiring or firing decisions (including his own), he made no true contribution to the firm's capital; he did not share in profits and losses; and he did not stand in a fiduciary relationship to his "partners." Based on the *Darden* factors, the court held that Simpson was an employee, and he was therefore entitled to assert his ERISA rights.[570]

Comment: The functional approach taken by the *Simpson* court under ERISA suggests a model that might well be followed by the IRS when adjudicating tax issues involving LLCs. Currently, a compensatory grant of a modest LLC membership interest operates to change the status of an individual from an employee when tested under the *Darden* factors to a self-employed individual.

F. Part-Time, Seasonal and Temporary Employees

Part-time, seasonal and temporary employees pose a unique set of challenges relating to the maintenance and operation of tax-qualified retirement plans. These plans universally require some measure of nondiscriminatory coverage. The extent to which these employees are required to be included for coverage or nondiscrimination testing purposes differs from benefit to benefit. In the case of tax-qualified retirement plans, plan sponsors face some tax-driven constraints if they want to exclude by class their part-time seasonal or temporary employees from plan coverage and participation. But ERISA and the I.R.C. are silent as to which employees must be covered. Once an employee is in an eligible class, ERISA and the I.R.C. specify the latest date on which participation must commence.

1. Indirect Age and Service Requirements

Section 410(a) establishes minimum age and service requirements that may be applied to tax-qualified pension, profit sharing and stock bonus plans. These requirements carry out Congress's mandate of broad-based plan participation. Under §410(a), once an employee is in an eligible class of employees, his or her plan participation may not generally be deferred beyond age 21 and the completion of one year of service.[571] This requirement differs from, and should not be confused with, the requirements of §410(b), which prescribe a minimum threshold for plan's coverage relative to the employer's entire workforce. As described at length in III.B.2., §410(b) requires nondiscriminatory coverage, not total coverage.

Example: Employer X has two divisions, Division A and Division B. Employer X maintains a defined benefit pension plan that covers only employees of Division A. In order to meet the requirements of §410(a), employees of Division A must become participants in the plan within the time frames established by §410(a). So long as the plan can establish nondiscriminatory coverage under §410(b), Division B employees can be denied participation, even if they attain age 21 and accrue a year of service, without violating §410(a).

As a consequence of §410(a), plan sponsors cannot simply exclude part-time, seasonal, or temporary employees as a class even if the class otherwise satisfies the requirements of §410(b). Reg. §1.410(a)-3(e)(1) provides that plan provisions may be treated as imposing age or service requirements even though the provisions do not specifically refer to age or service. Plan provisions which have the effect of requiring an age or service requirement with the employer or employers maintaining the plan will be treated as if they imposed an age or service requirement.

Part-time, seasonal or temporary employees may accrue 1,000 hours of service in a plan year, and to exclude them results in an indirect service requirement that violates §410(a)(4). Reg. §1.410(a)-3(e)(2) provides the following examples of indirect service requirements:

Example 1: Corporation A is divided into two divisions. In order to work in division 2, an employee must first have been employed in division 1 for five years. A plan provision that required division 2 employment for participation will be treated as a service requirement because such a provision has the effect of requiring five years of service.

Example 2: Plan B requires as a condition of participation that each employee have had a driver's license for 15 years or more. This provision will be treated as an age requirement because such a provision has the effect of requiring an employee to attain a specified age.

[569] This is true only if the plan is a top-hat plan under ERISA §201(2). Although the court did not reach the issue, it is not clear whether the plan was maintained "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." *See also* DOL Adv. Op. 90-14A and DOL Adv. Op. 92-13A.

[570] In reaching its decision, the court gave short shrift to the fact that, by agreement, partners may be excluded from governance and loss sharing, among other things, and it overlooked a partner's apparent authority to bind the firm. *See* Uniform Partnership Act §9(1) (apparent authority of partner), §16(2) (effect of consent to representation as a partner), and §18(e) (partner's management rights subject to modification by agreement).

[571] §410(a)(4) (requiring, in pertinent part, that any employee who has attained age 21 and accrued a year-of-service, and who is otherwise entitled to participate in the plan, must commence plan participation not later than an entry date specified in the plan that is the earlier of (i) the first day of the first plan year beginning after the date on which the employee satisfied such requirements, or (ii) the date that is six months after the date on which he or she satisfied such requirements). *See* Reg. §1.410(a)-4(b)(1).

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Example 3: A plan that requires one year of service as a condition of participation also excludes a part-time or seasonal employee if his customary employment is for not more than 20 hours per week or five months in any plan year. The plan does not qualify because the provision could result in the exclusion by reason of a minimum service requirement of an employee who has completed a year of service. The plan would not qualify even though after excluding all such employees, the plan satisfied the coverage requirements of §410(b).

Example 4: Employer A establishes a plan that covers employees after they retire and does not cover current employees unless they retire. Any employee who works past age 60 is treated as retired. The plan fails to satisfy the requirements of §410(a) because the plan imposes a minimum age and service requirement in excess of that allowed by this section.

Example 5: Employer B establishes plan X, which provides that employees covered by qualified plan Y will receive benefits supplementing their benefits under plan Y to take into account cost of living increases after retirement. Plan X is not treated as imposing age or service requirements.

Example 6: Employer C establishes a qualified plan satisfying the minimum age and service requirements. At a later time, entry into the plan is frozen so that employees not covered at that time cannot participate in the plan. The limitation on new participants is not treated as imposing minimum age and service requirements.

The matter was also addressed squarely in an IRS field directive issued November 22, 1994[572] dealing with plan provisions that exclude as a class all part-time employees (i.e., employees who work less than 40 hours per week). The IRS determined that this provision violates §410(a) irrespective of whether it satisfies §410(b).[573] Under §410(a)(1), a plan cannot require, as a condition of participation, that an employee complete a period of service extending beyond the later of the date on which the employee attains the age of 21, or the date on which he completes one year of service (or two years of service in the case of a plan that satisfies §410(a)(1)(B)(i)). Section 410(a)(3)(A) generally defines a year of service to mean a 12-month period during which the employee has not less than 1,000 hours of service. The IRS cited Reg. §1.410(a)-3(e)(1) for the proposition that plan provisions which have the effect of requiring an age or service requirement with the employer or employers maintaining the plan will be treated as if they imposed an age or service requirement. According to the IRS:

> Even assuming that the exclusion from plan participation of a class of part-time employees (employees who work less than 40 hours per week) would not cause a plan to fail the coverage requirements of §410(b) of the Code, the exclusion nonetheless imposes an indirect service requirement on plan participation that could exceed one year of service (or two years of service under §410(a)(1)(B)(i)). A plan may not exclude any part-time employee where it is possible for that employee to complete one year of service (or two years of service under §410(a)(1)(B)(i)). Accordingly, plans which exclude such employees violate §410(a) and §1.410(a)-3 of the regulations.

The 1999 unreleased TAM discussed in III.B.4. raises the question of indirect service requirements in the context of exclusions based on payroll codes. While the IRS acknowledged that it might be possible for a payroll-code-based exclusion to result in an indirect service requirement, the facts in the 1999 unreleased TAM did not support such a finding. According to the IRS, an employer has a legitimate business interest in knowing the cost of workers' compensation packages at the time the workers are engaged and that nothing in §410(a) prevents an employer from addressing these concerns through preventative measures including the plan language at issue. A stark example of an unsatisfactory payroll-code-based exclusion might involve an arrangement under which a plan sponsor assigned a particular, distinguishing payroll code to all of its part-time, seasonal and temporary employees and excluded employees with that payroll code from plan participation.

Section 410(a) does not prevent an employer from excluding workers based on criteria other than those that are, directly or indirectly, age or service based. This is the case even where there is a strong correlation between the excluded class and the class consisting of part-time employees. A private educational institution might, for example, exclude as a class from plan participation its entire adjunct faculty, which is defined to consist of all non-tenured faculty members hired to teach not more than two courses each semester. Whether these faculty members perform 1,000 hours of service is immaterial. What does matter is that, based on all of the surrounding facts and circumstances, the educational institution has a legitimate business interest in maintaining an adjunct faculty corps.

2. *Counting of Hours vs. Elapsed Time*

Section 410(a) generally requires that an employee who attains age 21 and has earned a year of service be admitted to plan participation within a prescribed period of time. Section 410(a)(3)(A) generally defines a year of service to mean an applicable 12-consecutive-month computation period during which the employee earns 1,000 or more hours of service. Reg. §1.411(a)-6(b) defers to the Labor regulations for the definition of hours of service.[574] 29 C.F.R. §2530.200b-3, in turn, allows

[572] This field directive is reproduced in the Worksheets, below. *See also* IRS Quality Assurance Bulletin (Feb. 14, 2006) (asserting that the IRS will scrutinize qualified retirement plan language that excludes classes of employees by reference to the number of hours they perform services for the employer).

[573] The IRS noted that a plan that contains a provision excluding part-time employees from participation but received a favorable determination letter might be entitled to retroactive relief under §7805(b).

[574] The elapsed time regulations were originally found in (former) Temp. 29 C.F.R. §2530.200b-9(a)(3)(ii) issued in 1976. ERISA Reorganization Plan No. 4 of 1978, 44 Fed. Reg. 1065 (1978), transferred jurisdiction over these rules from the DOL to the Treasury, and the final regulations were issued by the Treasury Department. The reorganization plan realigned the administrative

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plans to use the following equivalencies in computing hours of service for participation, vesting, and benefit accrual purposes: (1) hours worked; (2) regular time hours; (3) days of employment; (4) weeks of employment; (5) semi-monthly periods of employment; (6) months of employment; (7) shifts of employment; (8) equivalencies based on earnings.

Reg. §1.410(a)-7 also allows for the use of the elapsed time method of determining equivalencies. Under the elapsed time method of eligibility, vesting and benefit accruals are determined generally with reference to the total period of time that elapses while the employee is employed (i.e., while the employment relationship exists) with the employer or employers maintaining the plan. This method is designed to lessen the administrative burdens associated with the maintenance of time records by permitting each employee to be credited with his or her total period of service with the employer or employers maintaining the plan, regardless of the actual hours of service completed in any 12-consecutive-month period. The elapsed time method for determining years of service eliminates the necessity for an employer to keep track of employees' hours, but it also prevents the employer/plan sponsor from excluding part-time employees on the basis of hours of service.

Comment: Where plan administrators want to shorten the eligibility waiting period to something less than a year, this result can pose something of a dilemma. The 1,000-hour year of service is established by statute. But there is no authority for excluding an employee with less than 250 hours, for example, in a calendar quarter. Plans that take this approach must take the further step to ensure that the 1,000-hour requirement is met. So, as a practical matter, plans that allow participation after a day, month, or quarter must use the elapsed time method for eligibility purposes. One alternative to this approach is for plans to adopt a bifurcated eligibility provision under which actual hours are counted but employees that are regularly scheduled to work 1,000 hours in a year are permitted to enter the plan immediately, monthly or quarterly, etc. Other employees — i.e., those who are not regularly scheduled to work 1,000 or more hours — are admitted to plan participation as of the first day of the plan year next following the plan year in which they first exceed 1,000 hours of service.[575]

G. Contract Employees/Technical Workers

The rapid growth of the Internet spawned what became known in the technology sector as a war on talent as Internet and technology companies looked for workers with narrow and highly specialized programming and networking skills. Responding to this need, traditional consulting and staffing firms, as well as a new breed of Internet-based companies offering workforce management solutions, entered the fray.

While these vendors arrange to place contract employees and/or technical workers with client end-users, they use various approaches. A large consulting firm may keep on staff a cadre of technical specialists that are placed on assignments of varying length with client companies. At the other end of the spectrum, some Internet-based companies function as mere talent brokers that specialize in the procurement of technical talent. In between there are a host of arrangements that channel talent to end-users with varying degrees of control being retained by the middleman.

In each case, the identity of the employer for tax and benefit purposes is determined by applying the *Darden* factors. Where the intermediary is merely a broker, the worker will be either the employee of, or an independent contractor to, the end-user. The analytically more challenging arrangement involves the worker who is at least arguably an employee of the intermediary and is placed on long-term assignment with the end-user. A consulting firm, for example, may employ a talented computer programmer who is placed on extended assignment with the firm's clients. The identity of the worker's employer in this instance is not a foregone conclusion, and the relationship may change subsequently. The controls, supervision and oversight exercised by the consulting firm on the programmer's first assignment may deteriorate over time. If the consultant is the consulting firm's employee at the outset, the preponderance of the *Darden* factors may change over time such that the programmer is the employee of the end-user for tax and benefit purposes. The outcome has implications not only for the programmer but also for the employee benefit plans maintained by the firm.

H. Employee Benefit Plans of Joint Ventures

Corporate transactions increasingly are taking the form of joint ventures that involve the pooling of workforces. If the parties to the joint venture are either related entities under §414(b) or §414(c), or deemed to be under common control under §414(m), the participants in the joint venture become jointly and severally liable for certain benefits-related obligations.[576] These include pension plan funding obligations under ERISA §4001(b) and ERISA §4062, multi-employer withdrawal liability under ERISA §4001(b) and ERISA §4211, excise taxes under I.R.C. §4971, and health care continuation coverage under Reg. §54.4980B-2, Q&A-2(b). In the case of tax-qualified plans, the provisions of §410(b) (relating to coverage), §401(a)(26) (relating to minimum participation for defined benefit plans) and §416 (relating to the top-heavy requirements) must be satisfied on an aggregated basis. Welfare plans too are required to be combined for testing purposes.[577] And irrespective of whether the joint venture participants are related entities, it is not always clear whether workers are the common law employees of the joint venture or of a participant in the joint venture.

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responsibilities between the IRS and the DOL with respect to plans subject to ERISA and the Code. In general, it transferred to DOL exclusive rule-making duties, interpretive jurisdiction and exemptive authority over fiduciary responsibility and prohibited transaction matters. It transferred to IRS exclusive-rule-making duties, interpretive jurisdiction and variance and waiver authority over minimum standards for participation, vesting and funding.

[575] Such a plan eligibility provision might read as follows: Each Eligible Employee who is regularly scheduled to work at least 1,000 Hours of Service per year shall become eligible to participate in the Plan as of the Entry Date coincident with or next following the date on which he or she completes one (1) Hour of Service; provided, however, that any Eligible Employee who is not regularly scheduled to work at least 1,000 Hours of Service per year shall become eligible to participate in the Plan on the sixtieth (60th) day of the Plan Year immediately following the Plan Year in which he or she first accrues a Year of Service.

[576] *See generally* Serota, *Employee Benefits in Considerations in Joint Ventures*, The Tax Law., 477 (2001).

[577] §414(t) (covering plans described in §79, §106, §117(d), §125, §127, §129, §132, §137, §274(j), §505, and §4980B).

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Under §761(a), a joint venture that is not a corporation, trust or an estate is treated as a partnership. The manner in which a joint venture is treated for tax and benefits purposes turns in large part on whether it must be aggregated with the venture participants under the controlled group and affiliate service group rules. Two unrelated corporations that come together to form a joint venture ordinarily will not constitute a controlled group unless some other provision applies, such as the affiliated service group rules.

Prior to enactment of §414(m) (relating to affiliated service groups) in the Miscellaneous Revenue Act of 1980,[578] the joint venture participants were treated as the employees of the joint venture. In Rev. Rul. 68-370,[579] two corporations, M and X, entered into a joint venture for the performance of construction contracts awarded to the joint venture directly or assigned to it by M or X. The joint venture had its own bank account and its own employees. None of these employees performed services directly for M or X. The joint venture paid employment taxes on employees' wages, and it withheld income taxes. M also maintained a separate, noncontributory profit-sharing plan. At issue was whether M was required to take the employees of the joint venture into account in determining whether the profit-sharing plan satisfied the requirements of §401(a). According to the IRS, once the requisite employment relationship is established between the partnership and the individuals who are rendering services to the partnership, such relationship is also established between each corporate partner and the employees for purposes of §401 through §404 of the I.R.C. Since the employees of the joint venture were considered employees of M, the employees were required to be taken into account in determining whether M's profit-sharing plan meets the coverage and nondiscrimination requirements.[580]

Rev. Rul. 81-105 expressly repudiated this view. Although intended to illustrate the interaction among §401(a)(4), §410(b) and §414(m), the ruling also makes clear that, in the absence of an affiliated service group, the plans of the joint venture participants need not be aggregated for testing purposes.[581] The rule works as well in reverse. A plan that is maintained by the joint venture that is not part of the same controlled group of corporations or trades or businesses under common control, as the case may be, will not need to include employees of the joint venture participants.

Joint ventures pose a host of added concerns when defined benefit plans are concerned. If the joint venture participants are a part of the same controlled group of entities, the controlled group members are jointly and severally liable for any shortfall that might arise in the event of a distress termination of a defined benefit plan that is a single-employer plan.[582] ERISA §4001(a)(15) defines "single-employer plan" to mean any defined benefit plan (as defined in [ERISA] §3(35)) which is not a multiemployer plan. This definition includes a multiple employer plan, i.e., a plan that has two or more contributing sponsors that are not under common control. The general rule of ERISA §4062 would ordinarily make all contributing sponsors jointly and severally liable. Some relief is afforded, however, by ERISA §4064, which apportions the liability among sponsors of multiple employer plans and their respective controlled groups in proportion to their required contributions for the five years preceding termination. Thus, if one contributing sponsor is unable to satisfy its obligations, other sponsors should not be affected.[583] ERISA §4063(a)(1) imposes on plan administrators of single-employer plans that have two or more contributing sponsors the duty to notify the PBGC of the withdrawal of a substantial employer[584] within 60 days. The plan administrator must also take steps to determine the amount of the withdrawal liability.

[578] Pub. L. No. 96-605.

[579] *Obsoleted by* Rev. Rul. 81-105, §6.

[580] *See also* Rev. Rul. 60-379 (allowing the compensation paid by the joint venture to be attributed to the joint venture partner for purposes of the contribution deduction limitations).

[581] Rev. Rul. 81-105 *Ex.* 3 (professional corporations A and B each own half of P, a lock repair shop. Although both A and B utilize P's services, neither is a significant portion of P's business. The IRS found that there is no affiliated service group on these facts, and P's employees need not be included when testing the plans of A or B).

[582] ERISA §4042(a), ERISA §4062.

[583] *Cf.* ERISA §4064(b) (giving the PBGC the authority to determine the liability of each employer on any other basis prescribed by regulation).

[584] ERISA §4001(a)(2) (defining the term "substantial employer" to mean any contributing sponsor and its controlled group of entities that are responsible for 10% or more of all contributions to the plan for the plan year in which withdrawal occurs).

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V. Coverage of Contingent Workers Under Stock-Based and Incentive Plans

Stock-based compensation arrangements include both statutory and nonstatutory stock option programs and employee stock purchase plans. Nonstatutory stock options are those that are taxed under the rules of §83. Statutory stock options, such as incentive stock options under §422, are singled out for favorable tax treatment provided certain requirements are satisfied.[585] Section 423 governs employee stock purchase plans that allow for the tax-favored purchase of employer stock at a modest discount.[586] While tax considerations pervade all stock-based arrangements, the focus to date has been on §423 plans, principally due to the *Microsoft* case. Unlike the pension and welfare plans described in III.B. and III.E., above, they are generally not subject to regulation under ERISA. This means that non-tax worker misclassification issues are governed under state law.[587]

A. Nonstatutory Stock Options

Nonstatutory stock options can be granted to common law employees and independent contractors (including non-employee directors). Section 83(a) describes the taxation of property received in connection with the performance of services without reference or regard to the nature of the underlying employment relationship. The first sentence of Reg. §1.83-1(a) makes explicit what is implicit in the text of the statute by stating that §83 provides rules for the taxation of property transferred to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services by such employee or independent contractor. Therefore misclassifying a worker will not affect the income tax status of the arrangement.

Although §83 governs the income tax treatment of a nonstatutory stock option irrespective of whether the worker is a common law employee or an independent contractor, employment taxes are another matter. As described at length in II., it matters a great deal for these purposes whether a worker is a common law employee or an independent contractor. But the issues that arise in the context of nonstatutory stock options are the same issues that arise whenever this sort of misclassification occurs. Where property is transferred, the value of the property is treated as wages in the hands of a common law employee, but it is self-employment income in the hands of an independent contractor. Claims based on improper exclusion from a nonstatutory stock option plan arise when a worker is misclassified and he or she is denied plan participation as a result. Because most nonstatutory stock option plans limit participation and vest a great deal of discretion in the plan sponsor to determine who participates, these claims are not commonplace. But where such a claim is made, state law controls.

B. Incentive Stock Options Under §422

Unlike their nonstatutory counterparts, incentive stock options (ISOs) within the meaning of §422 are, in terms of benefits, limited to common law employees. ISOs may be granted for any reason connected with employment to employees of the corporation granting the option, a parent or subsidiary corporation of the granting corporation, or a corporation that assumes the options pursuant to §424(a), or a parent or subsidiary corporation of such corporation.

An option granted to someone other than a common law employee can never receive ISO tax treatment. Unlike most tax-favored employee fringe benefits, ISOs are not subject to any nondiscrimination or coverage rules. Thus, ISOs may be granted exclusively to prohibited group members. Taken together, these rules make worker classification much less of a problem when ISOs are concerned. If an independent contractor is inadvertently included, then the favorable tax benefits of the ISO are not available to the independent contractor, but the plan itself is not in jeopardy and the option is treated as a nonqualified option in the hands of the independent contractor. As in the case of nonstatutory options, claims based on improper exclusion from an ISO plan are a concern where a worker is misclassified and he or she is denied plan participation as a result. But also as is the case with most nonstatutory stock option plans, ISO participation is usually subject to a great deal of discretion.

Where an inclusion deferral election is made with respect to an incentive stock option under §83(i), relating to qualified equity grants of qualified stock, such option is no longer treated

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[585] *See* §421(a) (dealing with taxation of incentive stock options). The employee does not recognize taxable compensation income at option grant or exercise (but the spread between the option price and the stock's fair market value constitutes an item of adjustment for AMT purposes) and the employer cannot currently deduct the related compensation expense. In the case of stock acquired under an employee stock purchase plan, the discount (of up to 15%) is not taxable as income.

[586] Such plans are hereinafter referred to as §423 Plans. For discussions of statutory and nonstatutory stock options, see 381 T.M., *Statutory Stock Options*, and 383 T.M., *Nonstatutory Stock Options*, respectively.

[587] Stock-based compensation plans typically defer the receipt of income for a fixed term of years. In the case of incentive stock options under §422, that term cannot exceed 10 years. Where employee stock purchase plans are concerned, the compensation is current compensation. Benefits under these plans are either property or cash. As such, they are not welfare benefits within the meaning of §3(1) of ERISA. Accordingly, they are subject to ERISA only if they are pension benefits. Under ERISA §3(2)(A), a "pension plan" is defined as "… any plan, fund, or program which … (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond … ." By deferring compensation for a fixed period of years without reference to retirement, these plans escape characterization as a pension plan for ERISA purposes. *See* DOL Op. Letter 77-23 (Feb. 14, 1977) (employee stock purchase plan is not a pension benefit plan within the meaning of ERISA §3(2)), DOL Op. Letters 79-50A, 79-51A and 79-52A (three substantially similar qualified stock option plans of unrelated employer, each of which required that stock options granted thereunder be exercised no later than five years from the date of grant were not ERISA-covered pension plans). *But cf.* DOL Op. Letter 90-17A, which, while holding an employee stock purchase plan was not an ERISA-covered pension plan, added the following cautionary note: "You should be aware that the Plan can be viewed by the Department as a pension plan as a result of surrounding circumstances. Based on the facts provided, the Plan might be regarded as a pension plan as a result of surrounding circumstances if it is administered in a manner that has the effect of providing retirement income to employees, if it results in a deferral of income by employees extending to termination of covered employment or beyond, or if communications to Plan participants suggest that the Plan is established or maintained for the purpose of providing retirement income or to defer income to the termination of covered employment or beyond. For example, if an employer or any person acting directly or indirectly in the interest of an employer prevents or discourages participants' requesting or receiving a distribution of their property or reselling stock acquired under the arrangement, the Department may view the arrangement as a pension plan within the meaning of §3(2)(A) of ERISA." Accordingly, simply referring to a plan as a stock option or stock purchase plan is not sufficient to avoid regulation under ERISA. Rather, the plan must operate so as not to impermissibly defer the receipt of compensation to or beyond periods of covered employment.

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as an incentive stock option under §422 for income tax purposes.[588]

C. Section 423 Plans

The favorable tax treatment accorded employee stock purchase plans depends on the plan meeting certain enumerated requirements, the most important of which — from the perspective of worker classification — is that only employees of the employer sponsoring the employee stock purchase plan and the employees of parent or subsidiary companies (other than 5% owners)[589] may participate in the plan.[590] Reg. §1.423-2(b) requires that the plan document specifically limit participation to employees. Pursuant to Reg. §1.423-2(e)(5), whether an individual is considered an employee is determined under Reg. §1.421-1(h).

Under §423(b)(4), *all* employees of any corporation designated under the employee stock purchase plan must be included in the plan, other than the following: (1) employees who have been employed less than two years, (2) employees whose customary employment is 20 hours or less per week, (3) employees whose customary employment does not exceed five months in any calendar year, and (4) highly compensated employees (as defined in §414(q)).[591] Conspicuously absent from this list is any mention of employees who are subject to a collective bargaining agreement. Once it is established who is eligible to participate in the plan, there are certain permitted limits that affect plan participation. Section 423(b)(5)[592] allows the plan to limit the maximum amount of options that can be exercised under the plan. It also permits the plan to limit the amount of options each employee may purchase based on a specified relationship to total compensation or the basic or regular rate of compensation.

Reg. §1.423-2(a)(4) indicates that if an option is granted to someone other than an employee the option will not be treated as an option granted under an employee stock purchase plan, but the grant will not disqualify the plan or other options granted under the plan. If an employee is improperly excluded, however, then all options granted under the plan are denied favorable tax treatment.[593] This regulation has enormous consequences for employers that retain contingent workers, in general, and those who contract with PEOs, in particular. Where a plan impermissibly excludes even a single common law employee, the plan's tax benefits vanish.[594]

The risks associated with misclassifying workers in the context of a §423 Plan are detailed at length in III.B.3., in connection with the discussion of the *Microsoft* case. Simply put, if the freelancers and staffing employees were common law employees of Microsoft, then they are likely eligible to participate in the §423 Plan maintained by Microsoft Corporation. According to the Ninth Circuit and consistent with the requirements of §423(b)(4), the plan covered all employees of Microsoft. The court determined that the plaintiffs, as employees of Microsoft, were eligible to participate in the employee stock purchase plan.

Comment: Based on its understanding of Washington state law, the Ninth Circuit construed the adoption of the employee stock purchase plan by the shareholders and directors as an offer extended to all employees that was valid even if the employees were not aware of its precise terms.[595] Drawing on an analogy to pension law, the court rejected the notion that the benefits under the plan were in any way gratuitous. The court appears to have accepted at face value the findings made by the IRS in its earlier employment tax audit that the freelancers were common law employees.

Where an inclusion deferral election is made with respect to a stock option under §83(i), relating to qualified equity grants of qualified stock, under an employee stock purchase plan, such option is no longer treated as a stock option under a §423 plan for income tax purposes.[596]

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[588] §83(i), added by Pub. L. No. 115-97, §13603(a), §422(b), as amended by Pub. L. No. 115-97, §13603(c)(1)(A) (both sections effective with respect to stock attributable to options exercises, or restricted stock units settled, after December 31, 2017). For further discussion of §83(i), see 385 T.M., *Deferred Compensation Arrangements.*

[589] §423(b)(3).

[590] §423(b)(1); Reg. §1.423-2(b), T.D. 9471, 74 Fed. Reg. 59,074 (Nov. 17, 2009), corrected at 74 Fed. Reg. 67,973 (Dec. 22, 2009), applicable to options granted under an employee stock purchase plan on or after January 1, 2010, but taxpayers may rely on the regulations for any option issued under an employee stock purchase plan prior to January 1, 2010.

[591] *See* PLR 200547007 (plan that employer proposed to amend to exclude from participation any individual treated as an independent contractor or employee of another company, provided the individual satisfies one of the four exclusions, does not violate §423(b)(4)). Prior to TRA '86, those who could be excluded from an employee stock purchase plan included officers, persons whose principal duties consist of supervising the work of other employees, and highly compensated employees.

[592] As amended by Pub. L. No. 115-97, §13603(c)(1)(B). In PLR 201911002, the IRS ruled that the provisions of an ESOP did not violate §423(b)(5) by giving participants the ability to use the proceeds from loans made by their employer to purchase shares, even though some participants may have been unable to obtain the loans due to the applicability of the Sarbanes-Oxley Act.

[593] Reg. §1.423-2(a)(4) and §1.423-2(e)(4).

[594] While this result is required by the regulation, there is no reported case of the IRS denying the tax benefits of a §423 Plan as a consequence of improperly excluding an otherwise eligible common law employee. However, in situations such as this, the employer may want to approach the IRS for a closing agreement to take corrective action so that the plan is not disqualified.

[595] *Vizcaino v. Microsoft Corp.* (*Vizcaino II*), 120 F.3d 1006, 21 EBC 1273 (9th Cir. 1997).

[596] §83(i), added by Pub. L. No. 115-97, §13603(a), §423(d), added by Pub. L. No. 115-97, §13603(c)(1)(B)(ii) (both sections effective with respect to stock attributable to options exercises, or restricted stock units settled, after December 31, 2017).

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VI. The Impact of the Affordable Care Act (ACA) on Contingent Workers

A. Overview

The Affordable Care Act (ACA) is arguably the single most important piece of federal social legislation in more than a generation. Loosely modeled after a 2006 Massachusetts law,[597] the ACA overhauled the nation's health care financing rules by adopting an approach that included five key components: an individual mandate, an employer mandate, low- and moderate-income subsidies, public insurance exchanges of marketplaces, and associated tax and financing reforms. The broad policy goals of the law include slowing the rate of annual health care costs, increasing the quality of medical care outcomes, and expanding coverage.

The ACA works within, rather than disrupting, existing market-based legal and regulatory structures. It reforms but does not displace the private health insurance markets; relies on but does not displace employer-sponsored group health coverage; and expands but does not displace Medicare, Medicaid and other existing government programs. With nearly 18% of the U.S. economy being health care related, everyone is affected by it.[598] Health care providers, commercial insurance carriers, the Medicare/Medicaid complex, U.S. citizens and green card holders, and employers are all affected by the law.

The obligations that the ACA imposes on employers do not operate in isolation. Rather, they interact with other parts of the law's substantive provisions governing health insurance exchanges or marketplaces, and low- and moderate-income premium tax credits and cost-sharing reductions. In addition to imposing substantive legal requirements on employers, the Act also includes a series of procedural requirements that include notice and reporting obligations of particular interest to employers, among others. Where contingent workers are concerned, the principal ACA challenges arises under ACA Title I, Subtitle F, Part 2 imposing rules governing shared responsibility for employers. These rules, which are codified in §4980H, apply to applicable large employers — i.e., an employer who employed an average of at least 50 full-time (including full-time equivalent) employees on business days during the preceding calendar year.[599]

For a detailed discussion of the ACA rules governing employers generally, see 335 T.M., *Health Care Reforms — Implications for Employee Benefit Plans*, and 332 T.M., *Employer Shared Responsibility*.

[597] Chapter 58 of the Acts of 2006, *An Act Providing Access to Affordable, Quality, Accountable Health Care*, as amended.

[598] Centers for Medicare & Medicaid Services, National Health Expenditures by Type of Service and Source of Funds (Dec. 9, 2014), available at: http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/NationalHealthAccountsHistorical.html.

[599] §4980H(c)(2)(A); §4980H(c)(2)(E). Although the employer shared responsibility rules were slated to take effect on January 1, 2014, the effective date was delayed until January 1, 2015 by Notice 2013-45. The effective date was also delayed further in the case group health plans with non-calendar-year plan years, and for employers with 50 to 99 full-time and full-time-equivalent employees, that satisfy certain requirements. T.D. 9655, 78 Fed. Reg. 8544–8601 (Feb. 12, 2014) (preamble §XV.D.1 and §XV.D.6).

B. Section 4980H Summary

The Affordable Care Act (ACA) employer shared responsibility rules require employers to determine if they are an applicable large employer. This requires a calculation of the average number of full-time (including full-time equivalent) employees. While full-time and full-time-equivalent employees must be counted in determining applicable large employer status, assessable payments are based on the number of full-time employees only.[600] A full-time employee with respect to any month is an employee who is employed on average at least 30 hours of service per week.[601] Unless transition relief is available, each applicable large employer is subject to an assessable payment under §4980H(a) or §4980H(b) if any full-time employee is certified as eligible to receive an applicable premium tax credit or cost-sharing reduction from a public insurance exchange:

- §4980H(a) Liability

  Section 4980H(a) liability arises if the employer fails to offer its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan. Under this provision, if an employer fails to make an offer of coverage to at least 95% of its full-time employees, an assessable payment is imposed monthly in an amount equal to $166.67 (as adjusted) multiplied by the number of the employer's full-time employees, excluding the first 30.[602]

- §4980H(b) Liability

  Section 4980H(b) liability arises if the employer offers its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan that, with respect to a full-time employee who qualifies for a premium tax credit or cost-sharing reduction, either (i) is unaffordable or (ii) does not provide minimum value. If the employer makes the requisite offer of coverage, the assessable payment is equal to $250 (as adjusted) per month multiplied by the number of full-time employees who qualify for and receive a premium tax credit or cost-sharing reduction from a health insurance exchange.[603] The amount of the §4980H(b) liability is capped at the product of the §4980H(a) payment amount times the number of full time employees.[604] As a result, an employer that offers group health plan coverage can never be subject to a larger assessable payment than that imposed on an employer with the same number of full time employees that does not offer group health plan coverage.

[600] §4980H(a), §4980H(b); Reg. §54.4980H-4, Reg. §54.4980H-5.

[601] T.D. 9655, 78 Fed. Reg. 8544 (Feb. 12, 2014) (preamble §VII). §4980H(c)(4); Reg. §54.4980H-3.

[602] §4980H(a), §4980H(c)(1); Reg. §54.4980H-4. For 2015, the 95% amount was reduced to 70% and the 30 excluded employees was increased to 80. *See* T.D. 9655, 78 Fed. Reg. 8569–8577 (Feb. 12, 2014) (preamble §XV.D.7).

[603] T.D. 9655, 78 Fed. Reg. 8544 (Feb. 12, 2014) (preamble). §4980H(b)(1); Reg. §54.4980H-5.

[604] §4980H(b)(2).

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Minimum essential coverage includes coverage under an eligible employer-sponsored plan. An eligible employer-sponsored plan includes group health plans offered in the small or large group market within a state but does not include plans offering only excepted benefits as defined and described under the Public Health Service Act (e.g., stand-alone vision or dental benefits, coverage for a specific disease and hospital indemnity plans).[605]

Employer-provided health insurance coverage is deemed unaffordable if the premium required to be paid by the employee exceeds 9.5% of the employee's household income. Final regulations include safe harbors under which affordability is determined on the basis of an employee's income as reported on his or her Form W-2 (in Box 1), his or her rate-of-pay, or the federal poverty line instead of household income. The safe harbors also calculate affordability with reference to the premium for self-only coverage.[606]

Coverage is deemed to provide minimum value if the plan pays for at least 60% of all medical costs, without regard to copays, deductibles, co-insurance, and employee premium contributions.[607]

For further discussion of §4980H, see 332 T.M., *Employer Shared Responsibility*.

C. The Final §4980H Regulations

Reg. §54.4980H-1(a)(15) defines the term "employee" for §4980H purposes to mean:

> [A]n individual who is an employee under the common-law standard. See §31.3401(c)-1(b). For purposes of this paragraph (a)(15), a leased employee (as defined in §414(n)(2)), a sole proprietor, a partner in a partnership, a 2-percent S corporation shareholder, or a worker described in §3508 is not an employee.

Thus, temporary and contract workers provided by staffing firms and professional employer organizations to client organizations will, for §4980H purposes, be analyzed under the employment tax common law rules to determine if they are employees. The final regulations provide a special rule, applicable to various arrangements including staffing firms and PEOs as organizations offering coverage on behalf of another entity.[608] Under this rule, a client organization may be given credit for an offer of coverage made by a PEO or other staffing firm (in the typical case in which the PEO or staffing firm is not the common law employer of the individual).[609] The final regulations do not further explain or otherwise elucidate the typical case in which the PEO or staffing firm is not the common law employer, and the reference to PEOs and staffing firms is at odds with the long-standing industry position described above. Elsewhere the final regulations refer to a temporary staffing firm.[610] The following table summarizes the differing views:

	Temporary Staffing Firm	**Staffing Firm**	**Professional Employer Organization**
Industry View	Temporary staffing firm generally is the common law employer	Staffing firm generally is the common law employer	Client organization is the common law employer*
(Apparent) IRS View	Temporary staffing firm generally is the common law employer	Client organization generally is the common law employer	Client organization is the common law employer

* The "industry view" of PEOs as not the common law employer is based on Rev. Proc. 2002-21. But there is judicial authority to the contrary as discussed below.

D. Common Law Employer Status Under §4980H — Temporary Staffing vs. PEO

Historically — in theory and, for the most part, in practice — employees assigned by staffing firms and those employed under PEO arrangements have been treated differently with respect to their common law status. The former have generally been considered common law employees of the staffing firm; the latter are generally viewed as the common law employees of the client organization. Since few court rulings have explicitly dealt with the common law status of staffing firms or PEOs,[611] *Blue Lake Rancheria v. United States*,[612] is noteworthy, particularly because the facts are representative of the operations of most staffing firms as well as many PEOs. The case involved a claim by an employee leasing company (PEO) wholly owned by an Indian tribe for a payroll tax exemption under an I.R.C. provision that excepts services performed in the employ of an Indian tribe from the definition of employment for purposes of unemployment taxes (i.e., FUTA).[613] The appellant, Blue Lake Rancheria, established Mainstay Business Solutions as a for-profit business owned by and operated for the benefit of the tribe. Mainstay provided employee leasing and temporary staffing for small- and medium-sized businesses located in California, Hawaii, and Nevada. The case involved only the tribe's employee leasing operations, which the court characterized as follows:

> Mainstay contracted with each of its clients to hire the client's employees as its own and then "lease"

[605] §5000A(f)(2), §5000A(f)(3).

[606] Reg. §54.4980H-5(e)(2). Proposed amendments would provide safe harbors for an employer that offers an Individual Coverage HRA, and employer-provided account-based group health plan that is treated as being integrated with individual health insurance coverage when it is offered to individuals who enroll in individual coverage. *See* Prop. Reg. §54.4980H-5(e)(2), §54.4980H-5(f), REG-136401-18, 84 Fed. Reg. 51,471 (Sept. 30, 2019), proposed to apply for periods after December 31, 2019; taxpayers may rely on the proposed regulation for periods during any plan year of Individual Coverage HRAs beginning before the date that is six months following the publication of any final regulations.

[607] §36B(c)(2)(C)(ii); Reg. §1.36B-2(c)(3)(vi); Reg. §1.36B-6, added by T.D. 9745, 80 Fed. Reg. 78,971 (Dec. 18, 2015), applicable for taxable years ending after December 31, 2013.

[608] Reg. §54.4980H-4(b)(2). For further discussion of §4980H, see 332 T.M., *Employer Shared Responsibility*.

[609] T.D. 9655, 79 Fed. Reg. 8544, 8566 (Feb. 12, 2014) (preamble).

[610] T.D. 9655, 79 Fed. Reg. at 8556–57.

[611] *See, e.g.*, *Burrey v. Pac. Gas & Elec. Co.*, 1999 U.S. Dist. LEXIS 22619 (N.D. Cal. May 12, 1999) (holding that the staffing firm was a common law employer). The *Burrey* case is discussed in IV.A.2.d.(1).

[612] *Blue Lake Rancheria v. United States*, 653 F.3d 1112 (9th Cir. 2011).

[613] I.R.C. §3306(c)(7).

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> those employees back to the client. The client supervised the leased employees on a day-to-day basis, but Mainstay paid their wages, provided benefits, and performed other human resources functions. According to Mainstay, this arrangement allowed the client to free itself from H.R. responsibilities and focus on its business, and resulted in better benefits for employees.[614]

The claim arose when the tribe filed for a refund of approximately $2 million in unemployment taxes paid by Mainstay. The tribe claimed that the workers employed by the employee leasing company satisfied the requirements for the exemption under §3306(c)(7). Reversing the district court, the United States Court of Appeals for the Ninth Circuit agreed with the tribe, holding that the employee leasing company and not the client organization was the common law employer. The employee leasing company was, therefore, entitled to the exemption from employment taxes as an instrumentality of the tribe. Addressing the absence of direct worksite supervision by Mainstay, the court noted:

> Although the client, not Mainstay, supervised the leased employees on a day-to-day basis, the employees were required to comply with Mainstay's employment policies regarding such issues as smoking, telephone use, timekeeping, and breaks. In this sense, the leased employees were subject to the will and control of both Mainstay and the client company.[615]

Even though the Ninth Circuit found sufficient evidence of control by Mainstay despite the client's day-to-day supervision of the actual work being performed, control issues are so central to common law analysis that it may be prudent for entities utilizing staffing firms to require that the staffing firms include language in their staffing agreements conferring a broad staffing firm right to control the employees' activities at the worksite, even if that right will rarely be exercised.[616]

The Federal Circuit reached the opposite result from *Mainstay* in *Cencast Servs., L.P. v. United States*,[617] involving an entity (Cencast) that remitted payroll and employment taxes on behalf of motion picture and television production companies. Cencast had filed suit against the United States, seeking refund of employment taxes paid under the Federal Income Contribution Act (FICA) and the Federal Unemployment Tax Act (FUTA) for employees they placed with the production companies. The Federal Circuit held that (i) liability for employment taxes is determined by reference to the employees' common law employers, which were the production companies; and (ii) that the common law employers cannot decrease their liability by retaining entities such as Cencast to make the wage payments to the employees.

The particulars of Cencast's claim are instructive. When Cencast filed its employment tax returns, it treated each employee as being the common law employee of Cencast rather than the several production companies an individual would provide services to throughout a year. This treatment reduced the overall payroll tax burden because of statutory caps on both FUTA and FICA taxes. While both FICA and FUTA taxes apply to all remuneration for employment,[618] both place caps on the wages subject to the tax. For FICA purposes, §3121(a)(1) excludes remuneration above the [FICA] contribution and benefit base (as determined under §230 of the Social Security Act), and for FUTA purposes, each employer is only liable to pay taxes on the first $6,000 of wages paid with respect to employment. Thus, if a worker provided services during a calendar year to more than one production company, Cencast paid FICA and FUTA tax on wages only up to the applicable wage base and not on wages up to the applicable wage base for each production company hiring a worker. The court observed that "the amount of tax that was avoided is exactly equal to the additional amounts of FUTA and FICA tax that individual production companies would have been liable for had those companies conducted their own payroll services and filed their own tax returns."[619] The court sided with the government holding that the common law test applied and that the workers in issue were the common law employees of the production companies. In so holding, the court cited *Blue Lake Rancheria*, but its finding of common law employee status on the part of the production companies is merely assumed with little analysis. Nor is there indication that Cencast retained any contractual rights of control or, if so, whether that would make any difference to the outcome.

1. Short- and Long-Term Temporary Employees and Assignments

Staffing firms operating under the traditional temporary staffing model should generally qualify as common law employers for §4980H purposes because they typically satisfy more than enough of the salient factors under the multifactor test. These include recruiting, screening, and hiring the workers; assuming responsibility as the employer of record for payment of wages and benefits and for withholding and paying employment taxes; establishing employment policies governing employee job performance and conduct; and exercising the right to discipline, terminate, or reassign the employees.

The multifactor test factors are also present in newer forms of staffing in fields that include information technology, finance, engineering, and health care. Employees assigned to those jobs generally work for longer periods, are more highly

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[614] *Blue Lake Rancheria*, 653 F.3d at 1114.

[615] 653 F.3d at 1120.

[616] *See also Castiglione v. U.S. Life Ins. Co.*, 262 F. Supp. 2d 1025 (D. Ariz. 2003) (holding that a leasing company, rather than the company to which the leasing company leased employees, was the employer for ERISA purposes). In *Castiglione*, the leasing company agreed to ensure the recipient company's adherence to federal, state, and local tax laws, payroll, workers' compensation laws and to provide group health and life insurance. *Contrast Professional & Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225, 8 EBC 2153 (1987), aff'd, 862 F.2d 751, 10 EBC 1627 (9th Cir. 1988) (holding that a "management" leasing company operated by the petitioner was not the common law employer). In a reverse of the classic leasing arrangement that led to the enactment of §414(n), the petitioner approached owners of small professional practices such as medical doctors and offered to hire them and then lease them back to their professional corporations or businesses. The arrangement resulted in a rich benefit package to the professionals from which their employees were excluded. The court found that the professionals were not employees of the leasing company, primarily because the leasing company exercised no meaningful control over them.

[617] 729 F.3d 1352 (Fed. Cir. 2013).

[618] *See* §3121(a) (relating to FICA); §3306(b) (relating to FUTA).

[619] *Cencast*, 729 F.3d at 1358.

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skilled and paid, and as a consequence are more apt to be offered (and participate in) staffing firm-sponsored benefit plans. Though the case for common law employee status of these latter, longer term employees is less certain than in the case of short-term, high-turnover placements, it is nevertheless still compelling. And even if this is a much closer case, the parties retain at the margins the power to control the outcome based on the structure of the arrangement and the contractual terms under which they operate.

2. Placement and Temp-to-Perm Arrangements

Staffing firms often provide direct placement of workers, along with arrangements that start as temporary but lead to permanent employment, usually after a relatively short, fixed period of time (e.g., three months). In the case of placement-only services, the worker is directly hired by the client and once hired becomes the common law employee of the client organization.[620] In such cases, there is no worksite employee to be concerned with. In so-called temp-to-perm arrangements, the assigned employee should be viewed as the common law employee of the staffing firm under the principles described above during the temp phase of the arrangement.

3. Payrolling

Some staffing firms provide payrolling services, which present unique issues under §4980H. In the typical payrolling arrangement, a staffing firm simply manages the payroll for a subset of the current employees of a client organization in a manner similar to the services provided by a PEO. The common law standard that applies for §4980H purposes is in all material respects the same common law standard that applies to retirement and welfare plans. If the rules governing common law employee status were strictly applied to payrolling arrangements, then any retirement plans covering payrollees would be multiple-employer plans and any welfare plans would be MEWAs.

E. Offers of Coverage on Behalf of Unrelated Entity

The final §4980H regulations include a provision under which, if certain requirements are satisfied, an offer of coverage by a PEO or other staffing firm to an indivdual performing services for a client organization is treated as an offer of coverage made by the client organization.[621] The need for such a rule is perhaps best illustrated by an example:

> Employer X has 300 full-time employees, 100 of whom are retained through Staffing Firm Y. Employer X makes an offer minimum essential coverage to its remaining 200 full-time employees under an eligible employer sponsored plan maintained by Employer X. Under the terms of the staffing agreement, Staffing Firm Y must make an offer of minimum essential coverage to any full-time employee whom it places with Employer X under an eligible employer-sponsored plan maintained by Staffing Firm Y. If the employees placed through Staffing Firm Y are the common law employees of Employer X and not of Staffing Firm Y, then, in the absence of the rule governing offers of coverage on behalf of another entity, Employer X would owe an assessable payment under §4980H(a), since it would have made an offer of coverage to only 66% of its full-time employees. But if the conditions of the special rule governing offers of coverage on behalf of another entity are satisfied, then Employer X would be deemed to have made an offer of coverage to 100% of its full-time employees, thereby escaping exposure under §4980H(a).

In order to qualify for the special rule governing offers of coverage by unrelated employers, the final regulations require that 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 to the staffing firm for the same employee if the employee did not enroll in health coverage under the plan (the fee requirement).[622] The final regulations neither explain nor furnish a rationale for the fee requirement. But in their informal and nonbinding remarks, Treasury and IRS officials have expressed the view that the fee requirement is needed to preserve consistency with other provisions of the Code. Simply put, if group health plan coverage is provided by the staffing firm, but the worker is the common law employee of the client, then the worker will be unable to exclude reimbursements of medical expenses under §105(b); he or she will not qualify for the deduction for employer-provided group health plan premiums under §106(b); and his or her salary reduction contributions to a cafeteria plan will not satisfy the requirements of §125. The employer deduction for ordinary necessary business expenses under §162 could also be affected. Absent the fee requirements, staffing firms offering group health plan coverage to workers who are not their common law employees could be denied the business expense deduction.

Where the client organization satisfies the fee requirement, the plan under which the coverage is provided is deemed to be one to which the client organization contributes. If one follows the presumed logic of the fee requirement, therefore, the IRS views the plan as a multiemployer plan. It is, after all, a plan covering employees of two or more unrelated employers. The portion of the plan covering the employees placed by the staffing firm is, in effect, sponsored by the client organization. For staffing firms that have historically viewed themselves as common law employers and who invoke the rules governing offers of coverage by unrelated employers and its accompanying fee requirement — either prophylactically to address client concerns at the outset of an arrangement, or on later audit or examination — raise a number of concerns.

[620] *But see* Reg. §54.4980H-3(d) (relating to the look-back measurement period method for assessing full-time employee status of new variable hour, new seasonal, and ongoing employees); Reg. §54.9815-2708 (relating to the limits on waiting periods imposed in by Public Health Service Act §2708 as added by the Act). It is not yet clear whether the service during the "temp" and "perm" periods must be tacked for purposes of counting hours, or for purposes of measuring group health plan eligibility waiting periods.

[621] Reg. §54.4980H-4(b)(2). For further discussion of §4980H, see 332 T.M., *Employer Shared Responsibility*.

[622] Reg. §54.4980H-4(b)(2).

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1. MEWA Status of the Staffing Firm's Group Health Plan

If the workers placed with a client organization are covered under the staffing firm's group health plan and the staffing firm is determined not to be the common law employer, then that plan is, and is regulated as, a multiple-employer welfare plan. If the plan is fully insured, then it may violate the terms of the agreement with the carrier that is under the impression that it is insuring a single-employer plan. In addition, if the client organization is a small group, the plan may run afoul of the state's small group requirements. The arrangement must also file annually a Form M-1 with the Department of Labor. If the plan under which the staffing firm makes the offer of coverage is self-funded, then the arrangement would likely constitute an unlicensed insurance company for state law purposes, or, in the alternative, fail to satisfy any separate state law governing self-funded MEWAs.

2. Loss of Tax Exclusion Under §105 and §106, and Disqualification of the §125 Plan

Amounts paid or reimbursed under a group health plan to or on behalf of employees and their dependents are excludible from an employee's gross income under §105, and pursuant to §106 an *employee's* gross income does not include the value of group health plan coverage. Similarly, group health plan contributions made by *participants* are excluded from gross income if made under a properly structured cafeteria plan that satisfies the requirements of §125. Section 125(d)(1) defines the term "cafeteria plan" to mean a written plan under which all participants are employees. The term "employee" in each case contemplates application of the common law standard. Where a group health plan covers individuals who are not common law employees of the staffing firm, then the §105 and §106 exclusions are unavailable. Worse, under a literal reading of §125, the staffing firm's cafeteria plan fails to qualify as a cafeteria plan. If it was determined on audit or examination that employees who the staffing firm treated as their common law employees were the common law employees of the client organization, then these exclusions would be disallowed for the open tax years, and payroll tax adjustments would be required.

3. Impact on Other Benefit Plans and Programs

If a staffing firm determines in advance of entering into an agreement with a client organization that the employees being placed under the agreement are common law employees of the client, then other benefit programs may be affected. For example, if a staffing firm offers a 401(k) plan that covers the employees placed with a client organization, the plan would have to be structured as a multiple employer plan. This would require, among other things, separate testing of the employees assigned to the client. The problems that would arise on audit are similar though even more daunting, since the plan may already have one or more qualification failures that could only be corrected under the audit closing agreements program (rather than under the much preferred voluntary correction program or through self-correction).

4. Possible Claims Under ERISA for Benefits

Employees who are placed with a client organization and are subsequently determined to be common law employees of the client organization might have a valid claim for benefits under the group health plan of the client organization in a manner reminiscent of the *Microsoft* case (discussed in III.B.3., above).[623] Indeed, it was the result of employees being reclassified for employment tax purposes that led to claims being brought under ERISA and the Internal Revenue Code in that case. While client organizations can amend their group health plans and other benefit plans to include inoculation language that would expressly exclude reclassified employees, the §4980H shared responsibility calculations would still need to include these workers.

5. Where to Draw the Line

Short- and long-term temporary employees and assignments, placement and temp-to-perm arrangements, and payrolling fall roughly, though not perfectly, on a continuum. At one end of the continuum is low job security/high turnover found in the context of temporary staffing in the narrowest sense of the phrase. At the other end of the continuum is long-term job security of the sort represented by PEO. The middle of the continuum is occupied by longer-term assignments in such fields as information technology, finance, and engineering among others. But where does one draw the line? At some point do workers cease being common law employees of the staffing firm and become common law employees of the client organization, merely because of the passage of time? That cannot be the right test because it would implicate every service firm that provides employees to perform services on a long-term basis for other businesses — e.g., landscape contractors, building maintenance, food service, and security protection services, to name just a few, all of which are often performed under some degree of supervision and control by the client business.

[623] *See Vizcaino v. Microsoft Corp.*, 173 F.3d 713, 23 EBC 1209 (9th Cir. 1999); *see also Vizcaino v. Microsoft Corp.*, 120 F.3d 1006, 21 EBC 1273 (9th Cir. 1997), modifying 97 F.3d 1187 (9th Cir. 1996), cert. denied, 522 U.S. 1098 (1998).

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VII. ERISA Fiduciary Standards and Contingent Workers

ERISA does not require an employer or employee organization to maintain any employee benefit plans. The establishment and maintenance of such plans is entirely voluntary.[624] But once an ERISA-covered employee benefit plan is adopted, ERISA prescribes a host of procedural rules, including fiduciary standards, intended to safeguard the rights of plan participants and beneficiaries.[625] Under ERISA §404, a fiduciary is required to discharge his duties with respect to a plan (1) solely in the interest of the participants and beneficiaries; (2) for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan; (3) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; (4) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and (5) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of ERISA. A fiduciary who fails to observe these requirements is liable to restore plan losses and to disgorge ill-gotten gains.

A. The Time Warner/DOL Litigation

ERISA §404(a)(1)(D) requires fiduciaries to operate the plan in accordance with the documents and instruments governing the plan insofar as they are consistent with ERISA. As a consequence, plan sponsors are under a fiduciary duty to properly classify workers with respect to plan eligibility and participation, and misclassified workers may have a claim for fiduciary breach on this score. These issues were brought to the forefront in *Herman v. Time Warner, Inc.*[626] According to the DOL's complaint:

> • Time Warner divided its workers into two groups, (1) the Edit Group (consisting of journalists, photographers, graphic designers, and others who produce Time Warner's various publications), and (2) the Publishing Group (which handled the financial matters associated with publishing, including the Edit Group's budgets).
>
> • Workers were classified for payroll purposes as regular, project, supplementary, or temporary. Temporary employees were also referred to as Green Requisition Employees or Green Reqs. There was a separate class of individuals considered independent contractors.
>
> • A worker's classification determined whether he or she was able to participate in Time's employee benefit plans. Most of the plans excluded temporary employees, and independent contractors were excluded from all plans.
>
> • Time Warner and its various divisions and subsidiaries purposely misclassified workers as temporary employees and independent contractors when they were in fact regular, project or supplementary employees who would have been eligible for benefits had they been properly classified. Time Warner also was alleged to have manipulated breaks in service of temporary employees to maintain their temporary status and deprive them of the ability to become eligible for benefits.
>
> • The plan fiduciaries failed to apply the plans' terms properly to all eligible persons, identify all eligible employees and ensure that all eligible employees were included in the plans.

The DOL sought to hold members of the plans' administrative committee personally liable for losses, bar them from further service as plan fiduciaries, and appoint an independent fiduciary to oversee future plan operations. Time Warner filed a motion to dismiss, claiming that, because the claim was for benefits, only participants who were eligible under ERISA §502(a)(1)(B) could bring suit. The government countered that it was entitled to maintain the suit under ERISA §409, which relates to breaches of fiduciary duty, ERISA §502(a)(2), which relates to appropriate relief, and ERISA §502(a)(5), a catchall provision under which the government can seek injunctive relief. The court determined that the government's enforcement power under ERISA was sufficiently broad for the claim to proceed. In support of its holding, the court cited ERISA §502(a)(2), under which the DOL can sue to redress a breach of fiduciary duty, and ERISA §502(a)(5), under which the government can seek an order enjoining "any act or practice which violates any provision of this title, or … obtain other appropriate equitable relief (i) to redress such violation or (ii) to enforce any other provision of this title."

On November 17, 2000, Time Warner and the DOL announced a $5.5 million settlement under which Time Warner established three, separate settlement funds. Settlement funds A and B, each totaling $2.5 million, were intended to compensate misclassified temporary employees and independent contractors, respectively. Settlement fund C, totaling $500,000, was intended to compensate workers, in both groups, that had uninsured and unreimbursed medical claims exceeding $10,000 per year. Although fiduciary-related remedies were originally a part of the relief sought by the DOL, no plan fiduciaries were removed or sanctioned, and no independent fiduciary was appointed.

Comment: Given both the relative size and the limited scope of the settlement, it would appear that Time Warner

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[624] *Lockheed Corp. v. Spink*, 517 U.S. 882, 887, 20 EBC 1257, 1259 (1996) (finding nothing in ERISA requires employers to establish employee benefit plans nor mandate what kind of benefit employers must provide if they choose to have such a plan).

[625] As originally enacted, Title I of ERISA regulated certain substantive aspects of pension plans such as eligibility and participation, vesting and funding, but no such requirements were extended to welfare benefit plans. Substantive regulation of welfare plans has developed piecemeal in subsequent legislation. ERISA and other federal laws now contain the following substantive benefit-related mandates: (1) ERISA §609(d) and I.R.C. §4980B(f)(1) (relating to pediatric vaccines); (2) ERISA §711 (minimum length-of-stay requirements for pregnancies); (3) ERISA §712 (constraints on a plan's coverage of mental health benefits); (4) 42 U.S.C. §1395y(b) (relating to end stage renal disease); and (5) ERISA §713 (mastectomy coverage mandates). The historic changes to health care regulation enacted in the Affordable Care Act (ACA), Pub. L. No. 111-148, and Pub. L. No. 111-152, as amended, added additional substantive requirements. For a discussion of the ACA, see 335 T.M., *Health Care Reforms — Implications for Employee Benefit Plans.*

[626] 56 F. Supp. 2d 411, 23 EBC 2646 (S.D.N.Y. 1999).

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faired far better than many might have expected. But the outcome in this case should not obscure its larger message. The size and scope of the settlement indicate only that the DOL was unable to find abuses on the scale anticipated by its initial investigation. The non-monetary remedies requested by the DOL in the complaint, including the removal of interested fiduciaries and the appointment of independent fiduciaries, are no less viable as a result of its settlement of this case. The fiduciary aspects of worker misclassification are a concern for all employers, and the DOL's willingness to pursue these issues will only serve to embolden private litigants.

B. Other Misclassification Cases Under ERISA

A Sixth Circuit case, *Brown-Graves Co. v. Cent. States, Se. & Sw. Areas Pension Fund*,[627] also addressed these issues. That case involved a trucking company that was a party to a collective bargaining agreement under which benefits were furnished under a multi-employer plan to regular employees but not to casual drivers. The employer classified all of its new hires as casual drivers notwithstanding that many of these workers worked full-time. The court determined that the individuals in question were full-time employees rather than casual drivers and that the employer was required to make contributions on their behalf. Although the appellee in this instance was the multi-employer plan and not the Secretary of Labor, the underlying issues are similar.[628]

In *Cent. States, Se. & Sw. Areas Pension Fund v. Kroger Co.*,[629] the Seventh Circuit held that a grocery store chain must make pension contributions on behalf of certain of its Atlanta warehouse employees, classified by the store as casual employees, where the store classified all part-time employees as casuals. The claim arose under a collective bargaining agreement with two components: a master agreement, which applied to Kroger employees nationwide, and a local supplemental agreement, applicable only to Kroger's Atlanta facility. The master agreement called for pension contributions to be made for regular employees and differentiated regular employees from probationary and casual employees. Probationary employees were defined as new employees who worked on a trial basis for 30 to 60 days and who could be discharged at Kroger's discretion.[630] At the end of their 30- to 60-day probationary period, probationary employees became regular employees.

Casual employees were defined by the master agreement as employees hired on a short term basis, and no plan contributions were required on their behalf.

The local agreement did not differentiate between probationary and casual employees. It instead referred to employees as part-time or full-time without defining the two terms. Prior to 1977, Kroger classified all newly hired employees as probationary, but, after 1977, the company began classifying all new employees at the Atlanta facility as casual employees. In 1991, Central States brought an action under ERISA §515 seeking delinquent contributions for employees classified as casual employees from 1986 to 1989. The Seventh Circuit agreed with the District Court that part-time Kroger employees were not casual employees as defined by the collective bargaining agreement.

The plaintiff in *Kroger* did not bring its claim under the fiduciary standards of ERISA. Rather, the statutory basis for the fund's claim was ERISA §515, which obligates an employer that makes contributions to a multi-employer plan under the terms of a collective bargaining agreement to do so in accordance with the terms of such agreement. ERISA §515 was enacted in part to provide a federal cause of action under which plans could collect delinquent contributions. But as *Kroger* demonstrates, its remedies are not limited to collection matters. The defendant's actions most likely also gave rise to a claim under ERISA §404, and had the plan not been a multi-employer plan, the plaintiff's claim might just as well have been brought as a claim for breach of fiduciary duty.

Admin. Comm. of the Time Warner, Inc. Benefit Plans v. Biscardi[631] involved a suit for declaratory judgment by Time Warner against a group of independent contractors who made benefit claims under certain employee benefit plans of Time Warner, Inc. and a subsidiary, Targeted Media, Inc. The defendants worked as sales representatives under agreements that described them as independent contractors, and they filed their tax returns accordingly. However, they were subject to significant ongoing supervision by Time Warner. The workers subsequently filed benefit claims with the plans' administrative committee. The administrative committee denied the claims and filed for declaratory judgment in federal court. It asserted that the workers were not common law employees of Time Warner and therefore not entitled to benefits. Although the court determined that there was a genuine issue of fact as to whether the workers in question were common law employees under the *Darden* test, the court nonetheless granted Time Warner's motion for summary judgment. According to the court, the workers in question would have been ineligible to participate even if they were common law employees. In reaching this conclusion, the court first determined that, as to factual matters, the decision of the administrative committee was subject to review under the "arbitrary and capricious standard." It then concluded that the committee could reasonably interpret the terms of the various plans involved to exclude the defendants.

Comment: This decision represents something of a boon for employers. The plans in question, for the most part, had no specific language under which these workers would find themselves excluded unambiguously. Rather, the plans used terms such as "regular employees," "full-time employees," "regularly employed full-time employees" on the "regular payroll" or "active full-time or part-time employees" with a "regularly scheduled work week." The court saw these terms, together with the requirement that many plan contributions be made by salary reduction, as inconsistent with the position advanced by the defendants. As a result, the court upheld the Committee's decision under the arbitrary and capricious standard. While favorable, this is not a decision on which plan sponsors should place great reliance unless there is no other choice.

[627] 206 F.3d 680, 24 EBC 1129 (6th Cir. 2000).

[628] This case also involved the application of ERISA §515 that requires employers to make contributions to multi-employer pension plans according to the terms of the plan or underlying collective bargaining agreement.

[629] 226 F.3d 903, 25 EBC 1044 (7th Cir. 2000), amended by 241 F.3d 842 (7th Cir. 2001) (clarifying an error), *cert. denied*, 532 U.S. 990 (2001).

[630] 226 F.3d at 907.

[631] 25 EBC 2325 (S.D.N.Y. 2000).

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Montesano v. Xerox Corp. Retirement Income Guarantee Plan[632] involved a claim by certain contract workers who were hired through external staffing firms and sought coverage under a series of five employee benefit plans sponsored by Xerox Corporation. The plans in issue included the Retirement Income Guarantee Plan (RIGP), the Employee Stock Ownership Plan (ESOP), the Profit Sharing and Savings Plan (PSSP), the Rochester Medical Plan and the Employee Life Insurance Program. The plan's administrative committee rejected the plaintiffs' claims on the grounds that (1) they were not Xerox employees, (2) they were not on Xerox's payroll and they did not receive compensation from Xerox, and (3) they were excluded as "leased employees."

Citing *Renda* and *Crouch*, the plaintiffs first argued that, as common law employees, they were entitled to coverage. The court disagreed, holding instead that ERISA does not prevent employers from denying participation on any basis other that age or service. The plaintiffs next claimed that they were entitled to participate under the express terms of the plan. The court observed that Xerox never intended to cover these workers, and it also noted that the administrative committee had broad discretion to interpret the plan.

In the course of its opinion, the court gave some of the particulars of the relevant plan provisions. Although the dates of amendments differ from plan to plan, it appears that the plans were amended in the mid-1990s to specifically exclude workers retained though staffing firms. It also appears that most if not all of the plans excluded leased employees within the meaning of §414(n). By way of example, prior to 1996, the PSSP covered all of the employer's employees who met the relevant age and service criteria, but it excluded leased employees as defined in §414(n). In or about 1996, the PSSP was amended to specifically exclude employees retained through staffing firms. But the PSSP also defined compensation as compensation paid through the company's payroll system. The ESOP had similar eligibility and compensation provisions, but the amendment excluding staffing firm employees was adopted a year earlier. In contrast, the RIGP defined compensation as the total amount reported by the Employer to the Federal Government for withholding tax purposes.[633] For the reasons described in IV.A.2.d., and IV.A.2.e., it is not likely that the plaintiffs fit this definition. The court granted summary judgment to the defendant.

Comment: This is a close case that highlights the importance of the discretionary standard of review for employers. Both *Montesano* and *Biscardi* can be read to stand for the following proposition: Benefits can be denied to an employee hired through a staffing agency or firm in the absence of a specific plan exclusion if (1) the plan has a deferential standard of review, and (2) there is even the slightest ambiguity (such as a reference to payroll or income tax withholding) that the committee can use to support the denial.

> These cases share a common theme: Plan participation was denied based on worker misclassification and the workers sued for redress under ERISA. Under ERISA §502(a)(B), a participant or beneficiary may sue to recover benefits due to him under the terms of his plan, to enforce his rights under the terms of the plan, or to clarify his rights to future benefits under the terms of the plan. A participant may also bring suit under ERISA §502(a)(2) for a breach of fiduciary duty and under ERISA §502(a)(3),
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> (A) to enjoin any act or practice which violates any provision of this title or the terms of the plan, or
>
> (B) to obtain other appropriate equitable relief (i) to redress such violations or (ii) to enforce any provisions of this title or the terms of the plan.

In *Massachusetts Mutual Life Ins. Co. v. Russell*,[634] the Supreme Court effectively foreclosed claims against fiduciaries under ERISA §502(a)(2) by holding that ERISA §409[635] — the substantive provision that is enforced through ERISA §502(a)(2) — may not be used to furnish relief to individual participants. Rather, the Court found that ERISA §409 is intended to allow for recovery by the *plan*. As a consequence, plaintiffs were sometimes left without a remedy in circumstances in which equity might seem to require otherwise.[636] While *Russell* foreclosed ERISA §502(a)(2) as a basis for individual recovery, it was silent as to whether ERISA §502(a)(3) might provide participants with another avenue. This issue was answered in the affirmative in *Varity Corp. v. Howe*.[637]

Varity involved the transfer of employees to a newly established subsidiary. In order to entice employees to accept the transfer, company officials granted them assurances that their benefits would be secure. The truth of the matter was that the company to which the employees were transferred had a significant negative net worth, and it later failed. The Supreme Court held that the company was acting in its fiduciary capacity when it furnished assurances about the company's employee benefit plans, and that it misrepresented the facts. The court required the reinstatement of coverage (i.e., an individual, participant-level remedy) under ERISA §502(a)(3).

The relief available under ERISA §502(a)(3) is limited to appropriate equitable relief. In *Mertens v. Hewitt Assocs.*,[638] the Supreme Court held that the relief available under that section is limited to the forms of relief that are typically available in eq-

[632] 117 F. Supp. 2d 147 (D. Conn. 2000), aff'd in part, *vac'd and rem'd in part*, 256 F.3d 86, 26 EBC 1609 (2d Cir. 2001). *See Schultz v. Stoner*, 308 F. Supp. 2d 289, 32 EBC 2522 (S.D.N.Y. 2004) (workers on staffing companies' payrolls permitted to pursue claims that plan administrator wrongfully excluded them from retirement plans); *Danis v. Cultor Food Science, Inc.*, 154 F. Supp. 2d 247 (D. Ct. 2001) (employee briefly employed by acquiring company following merger not entitled to receive retiree medical benefits from new employer).

[633] 117 F. Supp. 2d 147, 153, n.3.

[634] 473 U.S. 134, 6 EBC 1733 (1985).

[635] ERISA §409 provides: "Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through the use of assets of the plan, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary."

[636] *Degan v. Ford Motor Co.*, 869 F.2d 889, 10 EBC 2438 (5th Cir. 1989) (finding no cause of action for fiduciary breach where employee elected separation pay in reliance on representation of union officials that he would still be eligible for early retirement benefits where the representations were erroneous).

[637] 516 U.S. 489, 19 EBC 2761 (1996).

[638] 508 U.S. 248, 16 EBC 2169 (1993).

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uity (e.g., injunction, restitution),[639] and that compensatory (i.e., money) damages were not available. As a result, misclassified workers will not likely get compensatory damages even where their exclusion is systematic or willful. But they will be entitled to benefits from which they were improperly excluded and they will be able to gain prospective admission to plans.

Comment: With perhaps the exception of the settlement in the *Time Warner* case, no cases to date have retroactively provided for welfare benefits. In *Crouch* and *Renda*, however, benefits under defined benefit pension plans were retroactively reinstated. The question yet to be addressed is the nature of the remedy under a §401(k) plan. This was raised but never ultimately decided in the *Microsoft* case.

The EPCRS safe harbor correction is to deposit to the account of the erroneously excluded participant an amount to compensate the individual for not being able to contribute to the plan. The amount to be contributed depends on the timing of the discovery of the error.[640]

C. ERISA §510

ERISA §510[641] was designed to protect an employee against retribution for exercising any right under a plan or ERISA and against interference with the attainment of any protected rights.[642] It does not broadly forbid all forms of discrimination; rather, it outlaws discrimination undertaken for purposes expressly made impermissible by terms of the plan or statute.[643] To prevail under ERISA §510, a plaintiff must show that the alleged discrimination was designed either to retaliate for the exercise of a right or to interfere with the attainment of an entitled right.[644] Section 510 relates to discriminatory conduct directed against individuals; it does not forbid discrimination relating to the plan in general.[645] An employment relationship must be substantially affected to trigger a violation of §510.[646] The worker classification aspects of ERISA §510 are in issue when an employer classifies or reclassifies a worker to prevent the worker from accruing or receiving plan benefits.

In *Inter-Modal Rail Employees Ass'n v. Atchison, Topeka & Santa Fe Railway Co.*,[647] the Supreme Court determined that the protections afforded by §510 applied to both pension benefits and welfare benefits, including rights that have not yet vested. Prior to *Inter-Modal*, a conflict existed among the circuit courts as to whether ERISA §510 protected non-vested welfare benefits. Because the vesting rules set out in ERISA apply only to pension plans, some courts and commentators were of the view that §510 should not apply in the case of welfare benefits. They reasoned that, in the absence of a contractual right to such benefits, an employer could at any time simply amend or revoke its welfare benefit plans. Accordingly, the protections of ERISA §510 would be meaningless if applied in the welfare plan context. In *Inter-Modal*, the Supreme Court rejected this view and instead adopted a broader reading of the statute, encompassing both pension and welfare benefits.

Seaman v. Arvida Realty Sales[648] involved the reclassification of a worker from a regular employee to an independent contractor. Arvida Realty Sales employed Seaman as a real estate salesperson. Pursuant to her employment contract, Seaman was entitled to health insurance coverage and participation in a §401(k) plan to which she and Arvida contributed. She and other salespersons were subsequently notified that they would be terminated in order that *Arvida* could eliminate the cost of providing benefits, although the health insurance and §401(k) plans were continued for other workers. The terminated employees were offered contracts as independent contractors, which did not provide for health insurance or §401(k) participation. Seaman refused to sign the new contract and was terminated. She charged that Arvida's conduct violated ERISA §510. The Eleventh Circuit held that the change in status could result in a violation of ERISA §510 if the employer intended the change to interfere with the future benefit rights of the worker. The court distinguished this situation from a bona fide plan amendment that reduces benefits. According to the court, a general, across-the-board reduction in benefits done for cost-cutting reasons and unaccompanied by discriminatory intent is not actionable under ERISA §510. But ERISA §510 is implicated where the employer's decision was directed at ERISA rights in particular.[649]

A similar finding of the requisite intent to support a claim under ERISA §510 arose in *Burditt v. Kerr-McGee Chemical Corp.*[650] Burditt began working for Kerr-McGee in 1984 as a clerical employee. She was expected to keep regular hours and conduct herself in a manner consistent with Kerr-McGee's regular employees. Kerr-McGee did, however, treat Burditt as an independent contractor: it issued a Form 1099 to her and did not withhold wages or pay employment taxes. In 1987, Burditt was asked to sign a contract, which stated that she was an independent contractor. In 1990, Kerr-McGee advised Burditt that her paychecks would henceforth come from a staffing firm and that she was a leased employee rather than an independent contractor. Burditt was subsequently terminated in 1995. Under Kerr-McGee's internal job posting procedure, Burditt was ineligible to transfer to another position because of her classification as a leased employee. However, had she been eligible for transfer, Kerr-McGee would have been obligated to retroactively award benefits for all of her years of service. Burditt sued, alleging that Kerr-McGee violated ERISA §510 when it classified her

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[639] Alan Hawksley, *What Relief Is Available as an Equitable Remedy Under Section 502(a)(3) of ERISA?*, 25 Tax Mgmt. Comp. Plan. J. 238 (1997).

[640] *See* Rev. Proc. 2021-30, Appendix A, §.05.

[641] ERISA §510 provides in relevant part: "It shall be unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate against a participant or beneficiary for exercising any right to which he is entitled under the provisions of an employee benefit plan … or for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan." Effective August 17, 2006, ERISA §510 was amended to extend protections to contributing employers of multi-employer plans. Pub. L. No. 109-280, §205.

[642] *Garratt v. Walker*, 164 F.3d 1249, 1252, 22 EBC 2143 (10th Cir. 1998).

[643] *Owens v. Storehouse, Inc.*, 984 F.2d 394, 16 EBC 1737 (11th Cir. 1993).

[644] 984 F.2d at 398. For a general discussion of ERISA §510, see 374 T.M., *ERISA — Litigation, Procedure, Preemption and Other Title I Issues.*

[645] *See also Deeming v. Am. Standard, Inc.*, 905 F.2d 1124, 1127 (7th Cir. 1990); *Aronson v. Servus Rubber Div. of Chromalloy*, 730 F.2d 12, 16, 5 EBC 1343 (1st Cir. 1984), cert. denied, 469 U.S. 1017, 5 EBC 2728 (1984).

[646] *Int'l Union v. Park-Ohio Indus., Inc.*, 661 F. Supp. 1281 (N.D. Ohio 1987), aff'd in part and rev'd in part, 876 F.2d 894 (6th Cir. 1989).

[647] 520 U.S. 510, 20 EBC 2825 (1997).

[648] 985 F.2d 543, 16 EBC 1689 (11th Cir. 1993).

[649] *See Morris v. Winnebago Indus., Inc.*, 950 F. Supp. 918 (N.D. Iowa 1996) (finding no violation of ERISA §510 where benefit reductions were motivated by general cost reduction considerations).

[650] 982 F. Supp. 404, 21 EBC 1943 (N.D. Miss. 1997).

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for 11 years as a non-employee so as to avoid paying her benefits. The court held that the complaint stated a viable cause of action, and it declined to grant the defendant's summary judgment motion as a consequence.

Sanders v. Amerimed[651] involved a claim for group health benefits by a former employee, John Sanders, who was never a participant or beneficiary in his employer's group health plan. The employer argued that Mr. Sanders was not entitled to benefits as a part-time employee, and as such, he lacked standing to bring a claim under ERISA §510. The court disagreed, holding instead that Mr. Sanders had standing based on ERISA's definition of participant and on evidence that the employer accepted his application and interviewed him for a full-time position. The implications for the ACA are immediately apparent: Capping the hours of an ongoing employee might result in the withdrawal of coverage or at least eligibility for coverage. *Marin v. Dave & Buster's Inc.*[652] raises this very issue.

Marin v. Dave & Buster's Inc. involved a proposed class action claim by an employee of Dave & Buster's, a large regional restaurant chain. The issue before the court was whether the employee had sufficiently pled an ERISA §510 claim when she alleged that her employer intentionally interfered with workers' benefits by cutting workers hours to make them ineligible for health-care benefits under the ACA. The Plaintiff worked at one of the restaurant chain's stores as a full-time employee until 2013, when her employer reduced her hours to approximately 10 to 25 per week. Allegedly part of a plan to reduce the number of full-time employees at stores nationwide, the employer also reduced other employees' hours so that the number of full-time employees at the store fell from more than 100 to approximately 40. Reducing the number of full-time employees enabled the employer to avoid ACA's employer mandate, which penalizes certain larger employers that provide health insurance that fails to meet minimum-value standards.[653]

The employer moved to dismiss the ERISA §510 claim, arguing that an employee must show more than a lost opportunity to accrue benefits to establish the claim. The employee had no entitlement to future health care benefits, the employer argued. Therefore, the employer could not violate ERISA §510 by making its workers ineligible for future benefits. Rejecting the employer's motion to dismiss, the court sided with the employee, saying that she had alleged that the employer's actions affected both current benefits and the ability to attain future benefits. The employee had sufficiently pled that her employer acted with an "unlawful purpose" when taking the adverse action of reducing her hours. Namely, the employee set forth evidence that demonstrated that the reason the employer had reduced workers' hours was to avoid the employer mandate, including an employee's Facebook posting stating that the employer stated at store meetings that it was losing money due to ACA, and an executive's statements acknowledging that the employer was making moves to avoid incurring increased costs under ACA. In order to prevail, the plaintiff class will need to establish a prima facie case by showing that employees were (i) entitled to ERISA protection, (ii) qualified for the position(s) in issue and (iii) discharged under circumstances that constitute discrimination. This will give rise to a presumption that an employer unlawfully discriminated against the employee. Dave & Buster's will then have the opportunity to demonstrate a legitimate, clear, specific and nondiscriminatory reason for its actions, and that it was not motivated by the reasons proffered by the plaintiffs, e.g., it was instead reacting to the high costs of ACA compliance. The burden of proof then switches back to the plaintiffs to show that the employer's rationale is a pretext. Dave & Buster's was clear about the reason for cutting workers hours. It was motivated by ACA costs. It appears, therefore that the outcome of the case will turn on whether Dave & Buster's can prove a legitimate nondiscriminatory reason for its actions.

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[651] 17 F. Supp. 3d 700, 58 EBC 2483 (S.D. Ohio 2014).

[652] 159 F. Supp. 3d 460 (S.D.N.Y. 2016).

[653] *See* §4980H. For a detailed discussion of the employer shared responsibility rules under the ACA, see 332 T.M., *Employer Shared Responsibility*.

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VIII. The Gig Economy

The terms "gig" or "on demand" economy mean and loosely refer an environment in which temporary positions are common. Organizations contract with purportedly "independent" workers for short-term engagements, generally using mobile technology. (The terms "gig economy," "on demand economy" and "on demand workforce" are used interchangeably in this work.) Business such as Uber, Lyft and Airbnb are exemplars of the business that have embraced the gig economy. Proponents of the gig economy claim that workers are attracted to the flexibility that that the positions offer.[654] On the other side are those that believe that on-demand arrangements merely externalize costs by laying a portion of the cost of employing labor on society at large.[655] At stake are larger issues of labor policy that go to the underlying architecture and regulation of labor markets, both domestic and foreign.

The common concern in any discussion of the gig economy is the possible subversion of federal or state law. Historically, some employers have classified employees as independent contractors to avoid providing benefits and to escape exposure under various employment laws, and/or to gain an unfair advantage over their competitors. These Federal and state laws generally require employees to pay minimum wage and overtime; abstain from discriminating in hiring, firing and other terms and conditions of employment; maintain safe and healthy workplaces; and contribute toward payroll taxes, among other things.

In the United States, the gig economy is regulated by Congress, the legislatures of the individual states and even municipal lawmaking bodies within the states. The laws that apply are those described in Section II., above, relating to an individual's status an employee (whether under the common law, economic realities or some other test) or independent contractor.

The challenge of applying existing legal categories to on demand workers was described by Judge Chhabria in *Cotter v. Lyft, Inc.*:[656]

> At first glance, Lyft drivers don't seem much like employees. We generally understand an employee to be someone who works under the direction of a supervisor, for an extended or indefinite period of time, with fairly regular hours, receiving most or all his income from that one employer (or perhaps two employers). Lyft drivers can work as little or as much as they want, and can schedule their driving around their other activities. A person might treat driving for Lyft as a side activity, to be fit into his schedule when time permits and when he needs a little extra income.
>
> But Lyft drivers don't seem much like independent contractors either. We generally understand an independent contractor to be someone with a special skill (and with the bargaining power to negotiate a rate for the use of that skill), who serves multiple clients, performing discrete tasks for limited periods, while exercising great discretion over the way the work is actually done. Traditionally, an independent contractor is someone a principal might have found in the Yellow Pages to perform a task that the principal or the principal's own employees were unable to perform — often something tangential to the day-to-day operations of the principal's business.

Judge Chhabria is acknowledging that the work relationships that make up the gig economy do not fit squarely into the existing legal definitions of "employee" and "independent contractor" status. The gig economy is organized around intermediaries that are usually, though not always, technology-enabled. The intermediary connects those in need of services with contractors who are able and willing to provide services. But is the intermediary an employer, a mere broker who identifies independent contractors or something else? The answer to this question is important. Employees qualify for a range of legally mandated protections that are not available to independent contractors, such as the right to organize and bargain collectively, workers' compensation insurance coverage and overtime compensation. A 2015 paper by the Hamilton Project[657] succinctly summarizes the conundrum:

> It is our view that labor and employment law has evolved over time in the United States to reflect a social compact between employees and employers. This social compact represents a synthesis between the desire to enhance the efficiency of the operation of the labor market (e.g., to overcome information asymmetries and imperfections) and to ensure that the employment relationship treats workers fairly in light of the unequal bargaining power that typifies most employee-employer relationships. This social compact has served the United States well and, in our view, should be preserved and protected unless there are compelling reasons to alter it.

Neither legislatures nor regulators — Federal or state — have been quick to address the regulation of the on demand economy.[658] (Section 530 of the Revenue Act of 1978 prohibits the IRS from issuing guidance on worker classification.)[659] The courts and state agencies, however, have been presented with and are beginning to rule on these questions. While the laws in issue to date have been state laws, it is only a matter of time before Federal laws will also be tested. Because the standards

[654] Press Release, The Five Faces of the On-Demand Economy (Feb. 3, 2016), *available at* http://investors.intuit.com/press-releases/press-release-details/2016/The-Five-Faces-of-the-On-Demand-Economy/default.aspx.

[655] Jonathan P. Hiatt & Lynn Rhinehart, *The Growing Contingent Work Force: A Challenge for the Future*, 10 Lab. Law. 143, 150 (1994).

[656] 60 F. Supp. 3d 1067 (N.D. Calif. 2015).

[657] Seth D. Harris & Alan B. Krueger, *A Proposal for Modernizing Labor Laws for Twenty-First Century Work: The "Independent Worker"* 6 (The Hamilton Project, Discussion Paper 2015-10, December 2015). The paper proposes the establishment of a new category of worker with some but not all the benefits and protections afforded employees.

[658] *Cf.* City of Seattle Municipal Code §6.310.735, "Ordinance Relating to Taxicab, Transportation Network Company, and For Hire Vehicle Drivers" (giving Uber, Lyft, taxi and other "for-hire" drivers the right to unionize). The U.S. Chamber Commerce has challenged the ordinance on Federal law preemption grounds.

[659] *See* Revenue Act of 1978, Pub. L. No. 95-600, §530, as amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, §170(a) (adding new subsection (d) to Section 530). Section 530 "shall not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, systems analyst, or other skilled worker engaged in a similar line of work."

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that apply to determine a workers' status and vary from state-to-state, and from those that apply for purposes of Federal laws, the results are not uniform. But there is a unifying theme, which is illustrated in the cases discussed below, i.e., that the tests the courts have developed over the 19th and 20th centuries for classifying workers are not very helpful in addressing this 21st century problem.

A. The Early Case Law

There has yet to evolve a comprehensive gig economy jurisprudence. Currently, the case law has been limited to the application of state unemployment laws, and the analysis has been confined to the mechanics of worker classification, i.e., are the workers in issue employees or independent contractors.

1. Cotter v. Lyft, Inc.

This action arose in the context of cross motions for summary judgment.[660] The plaintiffs, former Lyft drivers, claimed that Lyft owed them money for violations of the California Labor Code. Specifically, the plaintiffs alleged that, because Lyft misclassifies its drivers as independent contractors, the drivers were been deprived of California's minimum wage, reimbursement for work-related expenses, and other protections that California law confers upon employees.

Lyft's business model assumes the drivers are independent contractors. The court describes the Lyft business model in some detail. Lyft operates a smartphone application, or "app," through which passengers are matched with nearby drivers who are available to transport people in their personal automobiles. To be a Lyft driver, a person must download the app, submit his car for inspection, undergo some form of background check and submit to an in-person interview with a Lyft representative. The rider uses the app to hail a ride. That driver may then accept, decline or ignore the ride request. If the driver declines the request or ignores it for a specified period, Lyft's system sends the request to the next closest driver who is logged on. If that driver accepts the ride, he is "matched" with the rider and generally proceeds to pick her up and drive her to her destination.

To accept rides, a driver must log onto the Lyft app in "driver mode." Lyft provide three methods by which drivers could arrange to drive for Lyft on a given day: (i) drivers could submit requests for particular hours one week in advance and Lyft would approve some or all of these hours; (ii) if it was less than one week in advance, drivers could log onto a website and reserve any available hours or (iii) drivers could log onto driver mode at any time, without having a particular time slot approved or reserved, provided that Lyft determines that demand is not already being met by the drivers who reserved time through the reservation system.

Lyft tracks each driver's acceptance rate. Acceptance rates below the community standard trigger warnings and can result in deactivation of the driver's account. At the end of a ride, the app prompts riders to rate the ride on a scale of one to five stars. A drivers whose average star rating falls below a certain threshold may be terminated. Lyft's relationship with its drivers is governed in part by its Terms of Service. Under a section titled "Driver Representations and Warranties," each driver agrees that he (i) is at least 23 years old, (ii) he has a valid driver's license, (iii) he owns or has the legal right to operate the vehicle and is named on the insurance policy covering the vehicle, (iv) he will only use the vehicle that has been registered with Lyft, (v) his vehicle is in good operating condition, (vi) he will not "offer or provide transportation services for profit, as a public carrier or taxi service, charge for rides or otherwise seek non-voluntary compensation from Riders, or engage in any other activity in a manner that is inconsistent with such Driver's obligations under this Agreement," and (vii) he will not offer rides exceeding 60 miles. The Terms of Service also provides Lyft with broad rights to investigate and terminate drivers for any or no reason.

California law starts with the presumption that a person performing services is generally presumed to be an employee. The burden of proof to establish otherwise is on the service recipient. An individual who is classified as an employee is generally entitled to (among other things):

- Minimum wage and overtime pay,[661]
- Meal and rest breaks,[662]
- Reimbursement for work-related expenses,[663]
- Workers' compensation,[664] and
- Employer contributions to unemployment insurance.[665]

Employers are also required to withhold and remit to the state their employees' state income tax payments.[666] In contrast, independent contractors do not receive these protections.

According to the court, the principal question is, "whether the person [or company] to whom service is rendered has the right to control the manner and means of accomplishing the result desired." But the company need not exercise its full right of control for a worker to be deemed an employee. In addition, a finding of employee status for a particular worker or group of workers does not require that the company retain the right to control every last detail. Importantly, the court expressed the view that the right to terminate at will, without cause, is strong evidence in support of an employment relationship.

Beyond the primary question whether the principal retains the right to control the manner and details of the work, California courts look to a number of secondary indicia of the nature of a service relationship, which include:

> (a) Whether the one performing services is engaged in a distinct occupation or business;
>
> (b) The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist without supervision;
>
> (c) The skill required in the particular occupation;
>
> (d) Whether the principal or the worker supplies the instrumentalities, tools and the place of work for the person doing the work;

[660] 60 F. Supp. 3d 1067 (N.D. Cal. 2015).

[661] Cal. Lab. Code §1194.
[662] Cal. Lab. Code §226.7.
[663] Cal. Lab. Code §2802.
[664] Cal. Lab. Code §3700.
[665] Cal. Unemp. Ins. Code §976.
[666] Cal. Unemp. Ins. Code §13020.

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(e) The length of time for which the services are to be performed;

(f) The method of payment, whether by the time or by the job;

(g) Whether or not the work is a part of the regular business of the principal; and

(h) Whether or not the parties believe they are creating the relationship of employer-employee.

As is often the case, California law provides, and the Court admonishes that these factors should not be applied mechanically.

The Court denied the motions and ordered a trial.

Several things stand out in this decision. In stark contrast to Federal benefits and tax law standards, there is a state law presumption *in favor* of employee status. This puts Lyft at a disadvantage. But Lyft will get the benefit of many of the factors set out in the multi-factor test. For example, the worker supplies the instrumentalities, he or she is in control of the length of time for which the services are to be performed and he or she is paid by the job. Lastly, California, like the Federal tax code but unlike some other state laws, considers the intent of the parties, which one supposes is evidenced by the terms of a written agreement.

2. Rasier LLC v. State of Florida

Rasier involved a challenge before the Florida Department of Economic Opportunity by former Uber drivers for unemployment insurance. At issue was whether services performed through the Uber driver app constitute "employment" within the meaning of Florida Statutes §443.036(19), §443.036(21) and §443.1216.

According to the Commission:

> Uber is a technology platform that, for a fee, connects transportation providers with customers seeking transportation. The agreement between drivers and Uber specifies that the relationship is one of independent contractor, and the actual course of dealing confirms that characterization. Drivers have significant control over the details of their work. Drivers use their own vehicles and choose when, if ever, to provide services through Uber's software. Drivers decide where to work. Drivers decide which customers to serve. Drivers have control over many details of the customer experience. Drivers may provide services through, or work for, competing platforms or other companies when not using the Uber application.

On these facts, the Commission held that Uber operates not as an employer, but as "a middleman or broker for transportation services." In support of this result, the Commission explained that for employment to be subject to Florida law, the work must be performed by "[a]n individual who, under the usual common-law rules applicable in determining the employer-employee relationship, is an employee."[667] The Commission cited with approval *Keith v. News & Sun Sentinel*,[668] which held that, to determine employment status, "courts should initially look to the agreement between the parties, if there is one, and honor that agreement, unless other provisions of the agreement, or the parties' actual practice, demonstrate that it is not a valid indicator of status."[669] But if "the actual practice of the parties [ ] belie[s] the creation of the status agreed to by the parties, [then] the actual practice and relationship of the parties should control."[670] A court must "place special emphasis on the extent of the 'free agency' … in the means and method of performing … duties."[671] *Keith* further held that the analysis of employee status ought to be is consistent with the following factors:

(a) The extent of control which, by the agreement, the master may exercise over the details of the work;

(b) Whether or not the one employed is engaged in a distinct occupation or business;

(c) The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;

(d) The skill required in the particular occupation;

(e) Whether the employee or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work;

(f) The length of time for which the person is employed;

(g) The method of payment, whether by the time or by the job;

(h) Whether or not the work is a part of the regular business of the employer;

(i) Whether or not the parties believe they are creating the relation of master and servant; and

(j) Whether the principal is or is not in business.

Notably, there is here no presumption of employee status, and the intent of the parties is given particular deference. It is this latter item that seems to have persuaded the Commission that the petitioners were independent contractors and not employees. In their view, the agreement was between two co-equal, independent business enterprises that are separately owned and operated.

3. Berwick v. Uber Technologies, Inc.

Berwick[672] involved a claim by former Uber drivers before the Labor Commission of the State of California for unpaid wages, reimbursement of expenses, liquidated damages and waiting time penalties. The agreement between the parties provided, among other things, that Uber provided a mobile application the allowed "Users to connect with independent Transportation Providers." Drivers were entitled to accept, reject and select among the service requests; they had no obligation to accept any request; but following acceptance of a request, the

[667] Fla. Stat. §443.1216(1)(a)2.

[668] 667 So. 2d 167 (Fla. 1995).

[669] *Keith*, 667 So. 2d at 171.

[670] 667 So. 2d at 171.

[671] 667 So. 2d at 171–72.

[672] Case No. 11-46739 EK (June 3, 2015).

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driver was required to conform to Uber's specifications. The Commission determined that the drivers were employees for purposes of the California Labor Code.

The particulars of the specifications imposed on drivers were remarkably similar to the facts in *Cotter v. Lyft, Inc.*, discussed above. The car model had to be approved by Uber, it could not be more than ten model years old and it had to be in good operating condition. There were also detailed rules concerning acceptance of requests.

The Commission cited California Labor Code §95, which authorizes the Labor Commissioner to enforce all labor laws of the state. As was the case with Oregon, California law starts with an inference that an individual is an employee if personal services are performed as opposed to business services. The applicable criteria were established *S.G. Borello & Sons, Inc. v. Dept. of Industrial Relations*,[673] which established the following multi factor test:

- Whether the person performing services is engaged in an occupation or business distinct from that of the principal;
- Whether or not the work is a part of the regular business of the principal or alleged employer;
- Whether the principal or the worker supplies the instrumentalities, tools and the place for the person doing the work;
- The alleged employee's investment in the equipment or materials required by his or her task or his or her employment of helpers;
- Whether the service rendered requires a special skill;
- The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist without supervision;
- The alleged employee's opportunity for profit or loss depending on his or her managerial skill;
- The length of time for which the services are to be performed;
- The degree of permanence of the working relationship;
- The method of payment, whether by time or by the job; and
- Whether or not the parties believe they are creating art employer-employee relationship may have some bearing on the question, but is not determinative since this is a question of law based on objective tests.

The Commission placed a good deal of weight on the second factor, i.e., whether the work is a part of the regular business of the principal or alleged employer. In the Commission's view, the tendency is to find employment when the work being done is an integral part of the regular business of the employer. As the Commission observed, "Without drivers such as Plaintiff, Defendants' business would not exist." Uber, in the Commission's view, was not merely a neutral technologic platform. Uber was instead involved in every aspect of the business. And, although the drivers control the "tools" (here, their cars), they were obligated to register their cars with Uber and to conform to Uber's myriad standards.

B. Class Actions

O'Connor v. Uber Technologies, Inc.[674] is perhaps the highest profile gig economy claim to date. Filed as a class action in 2013, the case has largely been taken up with wrangling over class action status and choice of forum (i.e., court versus arbitration), issues which have already made their way to the Ninth Circuit.[675] Though much of the case to date has been taken up with (important) procedural items, a recent order by the district court denying Uber's motion for summary judgment provides a pretty complete glimpse of the facts and issues.

The court starts by describing the particulars of the Uber business model, which are consistent with *Berwick*. The decision does, however, provide a clear explanation of Uber's principal defenses. Uber claims that it is a technology company and not a transportation company. It posits further that drivers are not its employees but instead are independent contractors, and therefore not entitled to the protection of the California Labor Code. Uber contends it exercises minimal control over how its transportation providers actually provide transportation services to Uber customers, an important factor in determining whether drivers are independent contractors. Uber also notes that drivers set their own hours and work schedules, provide their own vehicles, and are subject to little direct supervision. Plaintiffs demur, of course, claiming that Uber exercises considerable control and supervision over both the methods and means of its drivers' provision of transportation services, and that under the applicable legal standard they are employees. The court determined that the question whether Uber's drivers are employees or independent contractors is an issue to be decided by a jury, and not the court on a motion for summary judgment.

As noted in *Berwick*, California law starts with a presumption that a worker who provides services is an employee. If the putative employee establishes a prima facie case (i.e., shows he or she provided services to the putative employer), the burden then shifts to the employer to prove, if it can, that the presumed employee was an independent contractor. In so doing, the extent of the putative employer's control is paramount. The right of control need not extend to every possible detail of the work; rather, the relevant question is whether the entity generally retains control over the worker's performance. In addition to the right to control, the court cites to a number of secondary indicia — i.e., a multifactor test — relevant to the employee/independent contractor determination. These additional factors include:

(i) Whether the one performing services is engaged in a distinct occupation or business;

(ii) The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist without supervision;

(iii) The skill required in the particular occupation;

[673] 48 Cal. 3d 341 (1989).

[674] Order Conditionally Granting in Part and Denying in Part Defendant's Motion to Stay, No. 13-cv-03826-EMC (Dec. 22, 2015).

[675] Order Granting in Part and Denying in Part Plaintiffs' Supplemental Motion for Class Certification, No. 13-cv-03826-EMC (Dec. 9, 2015) (holding that Uber's arbitration clause is unenforceable).

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(iv) Whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work;

(v) The length of time for which the services are to be performed;

(vi) The method of payment, whether by the time or by the job;

(vii) Whether or not the work is a part of the regular business of the principal; and

(viii) Whether or not the parties believe they are creating the relationship of employer-employee.

The court added five additional factors:

(1) The alleged employee's opportunity for profit or loss depending on his managerial skill;

(2) The alleged employee's investment in equipment or materials required for his task, or his employment of helpers;

(3) Whether the service rendered requires a special skill;

(4) The degree of permanence of the working relationship; and

(5) Whether the service rendered is an integral part of the alleged employer's business.

The case has yet to be heard on the merits. It is nevertheless noteworthy that Uber will have to overcome the presumption based in California law that the worker is an employee. What this and the previous cases nevertheless signal is that workers in the gig economy may be employees under one standard but independent contractors under another. This is particularly the case where one of the standards being applied, e.g., the I.R.C. or ERISA, does not start with the presumption of employee status.

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