Benefit Insights

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A non-technical review of qualified retirement plan legislative and administrative issues

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Do You Know Who Your Employees Are?

USA Today recently ran an article describing how many companies are using alternative work arrangements to meet staffing needs during the economic recovery. Such arrangements may include use of leased employees, independent contractors or part-time/seasonal workers, all of which are commonly referred to as contingent workers.

One of several reasons often cited is the savings in benefit-related costs; however, it takes careful planning to ensure benefit plans properly reflect those intentions. The analysis generally requires employers to answer three key questions:

1. Which workers are legally considered to be my employees?
2. What does my plan document say about employees?
3. Will my plan be considered discriminatory if I exclude certain workers?

Who Are Your Employees?

You may be thinking, "Of course I know who my employees are!" However, the answer can be much more complex than it seems and has tripped-up many well-intentioned companies. In fact, employers as large as Microsoft, Coca-Cola and Time Warner have found themselves in litigation over this very issue.

To avoid the complexities, some employers simply include all workers in their benefit plans, but this option also has its drawbacks. The federal laws governing retirement plans mandate that plans be maintained and operated for the exclusive benefit and in the best interest of employees. By covering workers that are not employees, a plan sponsor violates this foundational rule.

Perhaps the easiest way to examine the situation is through a series of examples, so let's consider the following basic fact pattern:

Spencer is a college student who is home for break and looking for work. Shady Oaks Golf Club is looking for temporary help but does not need to bring on full-time employees. Spencer speaks to Aaron, the hiring manager at Shady Oaks, and they discuss several arrangements.

Independent Contractor

Aaron tells Spencer that he can come on board as an independent contractor. He will work as

a groundskeeper and is to report to work daily from 7:30 a.m. to 5:00 p.m. and will use the club's equipment. His hourly compensation will be reported on Form 1099, no taxes will be withheld and he will not be eligible for benefits. Both agree to these terms in writing. Is Spencer an independent contractor or an employee?

Unfortunately, it's not as simple as pointing to Aaron and Spencer's agreement or the fact that Spencer will receive a 1099 instead of a W-2. The IRS has provided guidelines for employers to use in its so-called "Twenty Factor Test" which focuses on whether a company, Shady Oaks in this case, has the right to control the worker. Several of the factors include whether the company has the right to:

- Set the work schedule;
- Establish the work location;
- Pay by the time worked rather than by the job or on commission;
- Furnish equipment for the worker's use; and
- Require work-related training.

Based on these criteria, it is likely that Spencer is legally an employee of Shady Oaks even though he is being treated as a contractor. Apart from liability for the payroll taxes it didn't withhold from Spencer's compensation, Shady Oaks may also be required to provide retroactive benefits to Spencer due to the misclassification.

Employees Not Working Full-Time

Aaron hires Spencer as a W-2 employee but specifies that he will not receive benefits, because he is not working on a full-time basis.

This situation is much more straightforward in that Spencer and Aaron both consider Spencer to be an employee of Shady Oaks. The issue is whether or not he is somehow less of an employee such that he can be excluded from company benefits.

In 2006, the IRS issued a Quality Assurance Bulletin to address this issue. It indicates that employees who work other than full-time schedules are still employees and that the plan documents, not employment agreements, must be consulted to determine eligibility for benefits. Examples of classifications that are often mishandled include:

- Part-Time Employees: those who work less than a standard 40-hour work week;
- Temporary Employees: those who are employed for a limited period delineated by specific dates or the duration of a project;
- Seasonal Employees: those who work during a specific season such as retail workers during the holidays or snow-plow operators in winter; and
- Per Diem Employees: those who do not have a set work schedule but are called in as needed.

The list also includes those whose normal work schedule is less than a certain number of hours, e.g. someone who is normally scheduled to work less than 20 hours per week.

Based on the Quality Assurance Bulletin, Spencer is a regular employee whose eligibility for Shady Oaks' retirement plan must be determined by the plan document regardless of the side agreement he made with Aaron.

What Does the Plan Document Say About Exclusions?

Plan documents are generally written to include all employees unless a certain classification is specifically excluded. Common exclusions are independent contractors, union members and non-resident aliens. However, documents can be tailored to a company's needs by excluding others such as students, interns, groundskeepers, etc.

Proper Classification

Proper worker classification is key to knowing if the plan excludes certain individuals. In the 1990s, a group of workers classified as indepen-

dent contractors sued Microsoft, claiming they were entitled to benefits. Microsoft defended itself by pointing out that the plan document specifically excluded independent contractors. While the court agreed that the exclusion was in place, it ruled that the workers in question were not actually contractors but common law employees; therefore, they did not fall under the documented exclusion. Microsoft was ordered to pay nearly $100 million in back benefits.

While this is a high profile case involving a large company, the IRS is aware of the issue of misclassification and looks for it when auditing plans of all sizes.

Precise Document Language

Classification issues can sometimes be addressed by precise wording in the plan document. The Microsoft case prompted many document amendments to exclude workers classified as independent contractors on the payroll records of the company. This more precise exclusion takes the determination out of the realm of the common law definition of employee and ties it to how the particular plan sponsor classifies workers.

Another example of a classification that may require precision is that of student. If a plan excludes students, is the intention to exclude all students or just college students? What about a senior executive who decides to go back and earn an MBA? That person is a college student. Should he or she now be excluded from the plan? Careful planning and precise wording at the beginning can eliminate much of the frustration and liability that can arise later due to ambiguity.

Election to Waive Benefits

Employers will sometimes indicate that a particular individual waived benefits. In the above examples, Spencer agreed in writing to forego benefits. Again, the plan document must be consulted. Many retirement plans simply do not allow a participant to waive benefits. In that situation, Spencer's waiver cannot be applied to the retirement plan whether he wants the benefits or not. For plans that do allow waivers, regulations prescribe the process. Specifically, the waiver must be in writing, must indicate that it is irrevocable and must be signed before the employee becomes eligible. For a plan that provides immediate eligibility, that means the waiver must be signed before the employee's first day on the job.

What Does the Plan Document Say About Eligibility?

Once it is determined which classifications are covered by the plan, it is necessary to understand the age and service requirements an employee must satisfy to join. The law generally limits the maximum age requirement to 21 and the maximum service requirement to one year (defined as completion of 1,000 hours in a 12-month period) but plans are free to implement more generous rules.

This is where the part-time/seasonal/temporary classifications come into play. As noted above, these individuals must be treated as any other employees. That means if a plan permits employees to join after completion of 30 days of service, seasonal employees who remain employed for more than 30 days become eligible. Similarly, an employee who works 20 hours a week for a year becomes eligible for a plan that imposes the maximum wait of 1,000 hours in a 12-month period (20 hours per week x 52 weeks = 1,040 hours).

Furthermore, regulations require that service be combined for employees who are terminated and rehired within certain timeframes. If Spencer works for Shady Oaks during winter break, spring break and summer vacation all in the same year, his service during all three of those stints

is combined to determine if he has worked the requisite 1,000 hours.

The easy solution may seem to be to simply exclude these groups. However, the Quality Assurance Bulletin indicates that doing so will, in most cases, violate the maximum statutory eligibility requirements, in that it indirectly keeps someone out of the plan based on the amount of time they work even though that time may be greater than the one year maximum. It may be possible, however, to exclude these individuals by some other means. For example, if all of Shady Oaks' seasonal employees are groundskeepers like Spencer, they could write their plan document to exclude groundskeepers (type of work) rather than seasonal employees (length of service).

What About Nondiscrimination Issues?

There is one final step to determine if the plan can exclude contingent workers and that is ensuring that the exclusions do not violate the nondiscrimination requirements. The primary test involved is the ratio percentage test. While a full description of the test is beyond the scope of this article, it generally dictates that a plan cannot exclude any more than 30% of its Non-Highly Compensated Employees, i.e. non-owners and those who earn less than $110,000 per year. In other words, if the sum of all the excluded employees is less than 30% of the total number of NHCEs, the plan satisfies the ratio percentage test and the exclusions are permitted.

Conclusion

The use of contingent workers carries many benefit-related issues. It is possible, in many cases, to exclude them from retirement benefits, but all three components discussed above (proper classification, precise document language and a passing nondiscrimination test) are required. Given the complexities involved, it is very important for employers facing this challenge to work with knowledgeable experts who can provide guidance every step of the way.