

Contingent Workers – Consequences for Qualified Retirement Plans

Distinguishing common-law employees from independent contractors can be challenging. Mistakes in this area can trigger dire consequences for qualified retirement plans, like plan disqualification and participant lawsuits under ERISA. Plans should periodically review worker classifications for compliance purposes, paying particular attention to eligibility terms and definitions, as well as proper inclusions and exclusions of classifications for testing purposes. Waiting for an audit or a lawsuit to discover classification problems can prove costly and burdensome.

Background

Only “employees” can participate in a qualified retirement plan. This includes common-law employees, self-employed individuals who own all or part of the business that maintains the plan, and certain leased employees. Former employees and employees on a temporary leave of absence can continue to be eligible. Independent contractors can set up their own plans (e.g., an individual IRA), but are not eligible to participate in a plan maintained by a business for which they provide services — such plans are for the “exclusive benefit” of the employer’s actual employees.

Distinguishing common-law employees from independent contractors can be challenging. A key identifying characteristic of a common-law employee is the employer’s right to control the worker — even if the employer does not exercise that right. The IRS divides factors that provide evidence of control into the following [three categories](#) that an employer must weigh in making a determination:

Misclassification has other consequences, too!

While this *FYI* focuses on consequences for qualified retirement plans, keep in mind that misclassifying an employee can trigger liability under federal and state labor and employment, workers compensation, and tax laws. (See our [July 16, 2015 FYI Alert](#) on worker classification under the Fair Labor Standards Act.) It can also affect employer liability for assessments under the Affordable Care Act’s employer shared responsibility requirements. Additionally, remember that different laws may classify the same worker differently, depending on the applicable legal standards.

- **Behavioral.** Can and does the employer dictate what work the worker performs and how he or she performs it?
- **Financial.** How is the worker paid? Does the employer reimburse for expenses? Who provides the worker's tools or supplies?
- **Type of relationship.** Is there a written contract? What types of benefits does the employer provide the worker? What is the duration of the work relationship? What is the role of the relationship in the context of the employer's business? The key is to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in the determination.

An employer that is unclear about a worker's status can [ask the IRS](#) to review the facts and circumstances and determine if the worker is an employee or independent contractor.

Potential Consequences of Misclassification

There are several possible qualified retirement plan consequences when an employer misclassifies a worker. Mistakes of this nature are typically uncovered in the course of an agency audit or as a result of a participant lawsuit.

Increase in Benefits Costs

When more individuals are determined to be benefits-eligible employees, the plan's costs increase — both to reflect the benefits due as well as to make the necessary corrections.

To protect against these costs, some plans provide that if a worker is reclassified as an employee by a government agency or court, the worker does not become eligible to become a participant in the plan by reason of such reclassification. These provisions are called "Microsoft language," after a 1997 case where an appeals court determined that a group of individuals the company had considered independent contractors were actually retirement plan-eligible employees. Plan provisions can be drafted to exclude participation on a retroactive basis only, or on both a retroactive and prospective basis, provided the plan meets applicable coverage and nondiscrimination tests.

Demographic Failures

The Code's coverage and nondiscrimination rules aim to prevent qualified plans from providing a disproportionate amount of plan benefits to an employer's highly compensated employees. Misclassification as independent contractors of workers who should have been counted as employees can skew the census data used to conduct this testing — and may result in a demographic failure, meaning that the plan does not pass coverage and/or nondiscrimination tests.

Potential Plan Disqualification

The most severe consequence of misclassifying an employee as an independent contractor — and excluding the individual from plan participation on that basis — is the potential [disqualification](#) of the plan as a whole, meaning that the plan's trust loses its tax-exempt status. This worst-case scenario can result from a demographic failure like failing to pass coverage and/or nondiscrimination tests, as discussed above. Alternatively, it can result from an operational failure where the employer impermissibly excluded a common-law employee from participating in the plan on the grounds that the worker is an independent contractor.

But it's a rare plan that actually faces disqualification in light of the IRS Employee Plans Compliance Resolution System ([EPCRS](#)) program and the options it provides for correcting problems and getting back on track. The plan must correct the error and may be required to pay penalties before the IRS will determine that the plan is once again qualified.

Cause of Action Under ERISA

A misclassified employee could bring an action to claim retroactive benefits due or clarify rights to future benefits. He or she could also raise breach of fiduciary duty claims. The use of Microsoft language can minimize the risks of ERISA claims.

Proactive Strategies

Employers should periodically review their worker classifications for purposes of qualified retirement plan compliance. In particular, they should pay attention to:

- Plan eligibility terms and definitions of employee, independent contractor, and leased employee
- Consistency of classification-related definitions in all documents and communications, including SPDs and enrollment brochures
- Plan language on the treatment of workers following reclassification
- Service crediting for workers who have converted to employee status, where required
- Proper inclusions and exclusions of classifications for purposes of testing
- Written contracts with all independent contractors, to ensure that they effectively express the intent of the relationship

A qualified retirement plan that has incorrectly included an independent contractor can use EPCRS to correct this mistake.

In Closing

Waiting for an agency audit or participant lawsuit to learn about misclassifications can prove costly. Conducting periodic internal reviews of worker classifications allows qualified retirement plans to address these often tricky issues in a less burdensome way.

What about leased employees?

A leased employee is a worker who is not a common-law employee of the employer but provides services to an employer (1) pursuant to an agreement between the employer and a leasing organization, (2) on a substantially full-time basis for a period of at least a year, and (3) under the employer's primary direction or control. Leased employees present challenges to plan administration that are different from those that independent contractors pose, as they count for certain retirement plan testing purposes unless a safe harbor exception applies.

Authors

Julia Zuckerman, JD
Joanne Jacobson, JD, LLM

Produced by the Knowledge Resource Center of Conduent Human Resource Services

The Knowledge Resource Center is responsible for national multi-practice compliance consulting, analysis and publications, government relations, research, surveys, training, and knowledge management. For more information, please contact your account executive or email fyi@conduent.com.

You are welcome to distribute *FYI*® publications in their entirety. To manage your subscriptions, or to sign up to receive our mailings, visit our [Subscription Center](#).

This publication is for information only and does not constitute legal advice; consult with legal, tax and other advisors before applying this information to your specific situation.