

Who's an Employee and Why Does it Matter?

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SunGard Relius Education

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What we'll cover

- Why does employee status matter?
- Employee issues
 - Employee/independent contractor
 - Self-employed individuals
 - Shared employees
 - Leased employees
 - PEOs



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10 types of employees for qualified plans

- Common-law employees
- Self-employed individuals
- Full-time life insurance salespeople
- Shared Employees
- Leased Employees
- Domestic Employee of Foreign Affiliate
- Employees of a aggregated entity:
 - ◆ Controlled group
 - ◆ Common control group
 - ◆ Affiliated service group
- Employees under Code 414(o)

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Why does it matter for plan purposes if I'm your employee?

- Coverage and nondiscrimination tests are based on employees
- Plan eligibility is based on employment status
 - If you're not eligible, you generally can't sue under ERISA
- Exclusive benefit rule limits participation to employees



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Who's an employee?

The common law rules

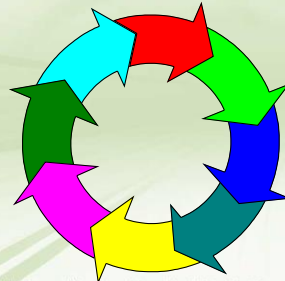


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ERISA definition is useless

- ERISA 1002(6) tells us that *“The term ‘employee’ means any individual employed by an employer.”*
- That definition is so circular it is meaningless.



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Darden Case

- Supreme Court in *Nationwide Mutual Insurance Co v Darden* (503 US 518, 1992) said that the standard, common law definition of employee controls for ERISA purposes.



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Darden factors

- Among the other factors relevant to this inquiry are
 - The skill required;
 - The source of the instrumentalities and tools;
 - The location of the work;
 - The duration of the relationship between the parties;
 - 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;
 - The method of payment;
 - The hired party's role in hiring and paying assistants;
 - Whether the work is part of the regular business of the hiring party;
 - Whether the hiring party is in business;
 - The provision of employee benefits; and
 - The tax treatment of the hired party.

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Professional & Executive Leasing Factors

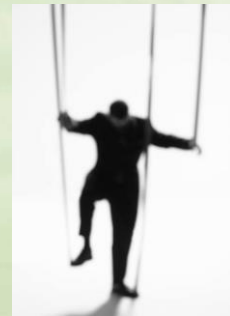
- The degree of control exercised over the details of the work;
- Investment in the work facilities;
- Opportunity for profit or loss;
- Whether the type of work is part of the principal's regular business;
- Right to discharge;
- Permanency of the relationship; and
- The relationship the parties think they are creating

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Control is the key

- According to IRS regulations and common law, an employer has the right to control and direct the employee's work. This control includes not only **what** is to be done, but also **how** it is to be done.
- By contrast, an someone hiring an independent contractor can specify the task, but does not direct how it is done.



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Old 20 Factor Test (Rev. Rul. 87-41)

- Has to follow instructions
- Gets training
- Integrated into business
- Cannot delegate
- Employer hires/ pays staff
- Continuing relationship
- Employer controls hours
- Work full-time for employer
- At employer's premises
- Employer sets order
- Reports
- Paid by hour or week
- Reimburse expenses
- Employer provides tools
- No investment in business
- No profit or loss
- Just one customer
- Service not for others
- Fire/Quit any time

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Other court developed tests

- Intent of the parties
- Industry practice or custom
- Independent contractor agreement
- Employee benefits



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Audit Guidelines/IRS Pub 15-A



- Behavioral Control
- Financial Control
- Relationship of the Parties

Download at

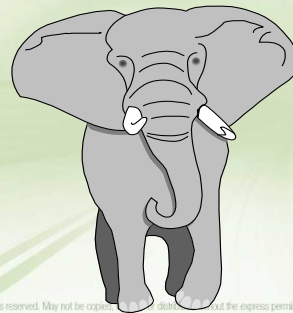
www.employerbook.com/Resources.html

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Look at the entire relationship

- No one factor controls
- Number of factors on one side or another doesn't control
- All factors must be weighed and considered
- Independent contractor agreements can't change the underlying reality



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Shades of Gray

- Frequently, the determination of employee status isn't a matter of "black and white."
- Legal counsel probably ought to make the call
- IRS has a form (SS-8) to request a formal ruling on employee status



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Guessing Wrong

- Dead Wrong, Inc. has a top-heavy safe harbor 401(k) plan providing a mandatory fully vested 3% profit sharing and a discretionary PS contribution.
- The plan provides that all employees with 1 YOS participate (no other exclusions).
- DWI has erroneously treated Jane as an independent contractor.
- *What are the possible consequences of DWI's mistake?*

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The Wages of Sin


- IRS problems
 - Coverage satisfied?
 - Failure to provide opportunity to defer
 - Failure to provide 3% QNEC
 - Incorrect PS allocation/nondiscrimination
 - Failure to provide TH minimum
- Jane can sue
- DOL can sue
- Quick! Put her in; provide makeup contributions plus interest



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Too Many Employees

- Safety Pins First treats Dave as an employee even though he's actually an independent contractor, figuring they'd rather be safe than sorry. 
- Dave defers to the SPF 401(k) plan for its salaried employees and receives allocations of the discretionary PS contribution.
- *What potential problems are there?*

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No safety in being wrong!


- IRS problems
 - Coverage being done incorrectly
 - Plan fails exclusive benefit rule
 - PS contribution misallocated
 - Problems deducting Dave's contribution
- Dave's can't exclude deferrals from income
- Other employees can sue; they're losing allocations to Dave



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You can exclude misclassified workers

- 1999 IRS Tech Advice said it was OK.
- Courts have approved such clauses. 
- Make sure they are *clear*.
- Don't exclude IC's per se. The exclusive benefit rule does that. Exclude employees who are *classified* as independent contractors.
- Exclusion clause won't guard against 410 violation. Use it with care.
- Make sure you have a Firestone clause which gives the administrator discretion to interpret plan.
- **No clause substitutes for getting it right in the first place!**

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Payroll tax issues

- Generally, employee for payroll taxes means employee for retirement plan status
 - Except for “statutory employees”
- Congress, IRS, and states trying to correct worker misclassification
 - Could change worker status for plan purposes
- Revenue Act of 1978, Section 530 gives payroll tax relief for reasonable, consistent treatment of worker as independent contractor
 - But no retirement plan relief

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Self-employed individuals are treated
as employees

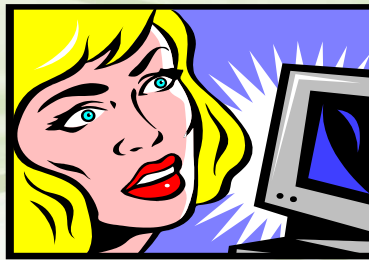


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A self-employed individual is:

- A sole proprietor
- A general partner in a partnership
- An owner of an LLC or other entity taxed as a partnership



Earned income is key



- A self-employed individual must either:
 - Have earned income in the current year; or
 - Worked in a business that would have generated earned income if it were profitable; or
 - Previously been treated as a self-employed individual for the business

Earned income is:

- Net earnings from self-employment (i.e., self-employment taxable income)
- From a business in which the individual's services are a material income producing factor
- Adjusted for pension rules:
 - Deduct 1/2 SE tax
 - Deduct pension contribution



If you are a self-employed individual:

- You are deemed to be an employee of your business
- Your compensation is your earned income
- Your proprietorship or partnership is deemed to be your employer and can sponsor a plan in which you participate

Sole proprietor



- Janice owns and operates a used bookstore as a sole proprietorship. *Can she set up a retirement plan covering herself?*
- Suppose Janice has never worked in the store. Instead, she leaves everything to a hired manager. However, she still pays self-employment tax on her Schedule C income. *Can she set up a retirement plan covering herself and her employees?*

Partners



- Bruce is a partner in an unincorporated law firm. That makes him a self-employed individual. *Can Bruce set up a plan covering himself?*
- Sue has a successful internet consulting business. Sue wants to make her 3-year-old daughter a partner. The daughter will receive a K-1 and pay self-employment tax on her share of partnership income. *Can the partnership cover the daughter under a plan?*

Shared Employees

It's worse than you think!



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Who is a shared employee?

- Someone who works for (and under control of) more than one business at a time.
- **Example:** Dean and Laura share a medical office. They pay rent, phone, and staff expenses from a single bank account. All employees (receptionist, billing clerk, nurses) are available to each doctor and each doctor shares in personnel decisions. The staff are shared employees.
- The result is the same if Dr. Dean pays them “for convenience”

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Shared employees work for all sharing employers at the same time

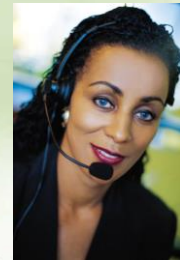
- Each is the employer simultaneously and credits all hours of service
- Each employer is deemed to pay its pro rata share of the employee's compensation



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Shared staff

- Dr. Laura and Dr. Dean share an office and their staff members, including two nurses, a filing clerk, and Wanda the receptionist. Wanda works 1,900 hours per year at the office for \$30,000 in compensation (which Dr. Dean pays for convenience).
- *Will Wanda ever have a year of service with either doctor?*
- *What is Wanda's compensation with Dr. Laura?*



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Shared employee plans

- Doctors Laura and Dean have different ideas about retirement plans. *What do you think of these arrangements:*
 1. Dr. Dean (who pays the staff) will cover them under his 401(k) plan. Dr. Laura will set up her own defined benefit plan.
 2. Dr. Dean will cover the staff for half their salary in his 10% money purchase plan and Dr. Laura will cover the staff for half their salary in her 401(k) plan.
 3. Dr. Dean and Dr. Laura will set up a multiple employer plan for themselves and the staff to which both will contribute.

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Leased Employees



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Leased Employee Terms

- **Leased Employee:** Worker who is on the payroll of one company but works for another. Must meet specific Code requirements.
- **Leasing Organization:** (Sometimes called staffing firm or Professional Employer Organization [PEO]). Leased employee is on their payroll.
- **Recipient:** (Sometimes called the PEO's Client Organization [CO]): Company for whom leased employee works. Recipient pays leasing organization for leased employee services.

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414(n) definition of a leased employee

1. ***Not an employee of the recipient***
2. Under the recipient's primary direction and control
3. Provides services to recipient under agreement with the leasing organization
4. Performs services for recipient on a substantially full-time basis for 12 months



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Common law employees of recipient aren't leased employees

- The Code says so
- Congressional reports say so
- Notice 84-11 says so
- The courts say so
 - Case after case for years ruled most leased employees are common law employees of the recipient



How do you decide who's the employer?

- Look at the standard common law tests
- Look at the whole relationship, not just the paperwork
- Let legal counsel make the decision



What happens if the recipient is employer?

- Staffing firm **cannot** cover worker under a plan, unless recipient cosponsors it.
- Recipient treats them just like all other common law employees.
- Clause excluding “leased employees under 414(n)” does nothing.
- Recipient ignores staffing firm’s plan for coverage, nondiscrimination, and limits

Who's the employer?

- *In each of these cases, decide whether the staffing firm or the recipient is more likely to be considered the common law employer of the worker:*
 - a) Astaire Temps provides temporary office staff, generally for assignments of two weeks or less

Staffing firm or recipient?

- b) Roger fires all 10 of his office employees on Friday. They all go back to work for him on Monday, but now they are on the payroll of Sandy's Staffing Firm. Next year, Roger moves all the employees over to Tommy's Temps.
- c) Macroshaft obtains many of its programmers from "temp" firms. They do the same jobs as Macroshaft employees, often working side by side, providing regular reports to management. Often they will work for Macroshaft for years at a time.

Staffing firm or recipient?

- d) Missing Man Locator Service's CFO is in the Army Reserves and has been called up to active duty. MMLS calls Bookkeepers Galore to hire a temporary CFO/controller to serve in the interim, probably at least a year, maybe more. The new CFO will remain on Bookkeeper Galore's payroll, but will otherwise function under MMLS control just as though she was an MMLS employee.



I'm your leased employee. So what?

- You treat me as an employee for purposes of retirement benefits under:
 - ☑ Code §401(a)(3), §401(a)(26) & §410 participation/ coverage rules.
 - ☑ Code §401(a)(4) nondiscrimination requirements.
 - ☑ Code §401(a)(7) and §411 vesting requirements.
 - ☑ Code §401(a)(16) and §415 limits on contributions and benefits.
 - ☑ Code §401(a)(17) compensation limits.
 - ☑ Code §408(k), (p) SEP rules and SIMPLE rules.
 - ☑ Code §416 top heavy rules.
 - ☑ Code §401(a) exclusive benefit rule.
 - ☑ Code §404 deduction limits.

Compensation and benefits

- Recipient is deemed to have paid leased employee the compensation that the PEO paid him or her for services for the recipient.
- Recipient is deemed to have provided contributions for leased employee to leasing organization's plan.

You can exclude leased employees

- They have the same status as other employees, which can be excluded, but must be counted in meeting coverage tests.
- **Suggestion:** Exclude workers on the payroll of another company, not just “leased employees.”



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PEO Issues

- PEO's can no longer have single employer plans covering their worksite employees
- But, they can offer multiple employer plans cosponsored by some or all of their clients.
 - The PEO's client (recipient) is treated as employer for its worksite employees in the multiple employer plan

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Health care issues

- Under the pay or play regulations, employee means common law employee
- Employee does not include:
 - Self-employed individuals
 - True leased employees
 - 2% S Corporation shareholder
 - Statutory independent contractor (real estate agents)