VI. [Reserved]

VII. Core Concepts: Eligibility

A. The Concept of Eligibility

B. Eligibility Condition #1: Participation Limited to Common-Law Employees, Partners and Sole Proprietors, Some Leased and Statutory Employees

C. Eligibility Condition #2: Participation Limited to Class of Eligible Employees Defined in Plan

D. Eligibility Condition #3: Participation Limited to Employees Who Satisfy Minimum Age and Service Requirements

E. Eligibility Condition #4: Participation Delayed Until Plan Entry Date

F. Rules for Crediting Eligibility Service

G. Eligibility Rules for Rehired Employees

H. Preventing Mistaken Exclusion of Eligible Employees

I. Waiver of Participation

J. Maintaining Eligibility Records

A. The Concept of Eligibility

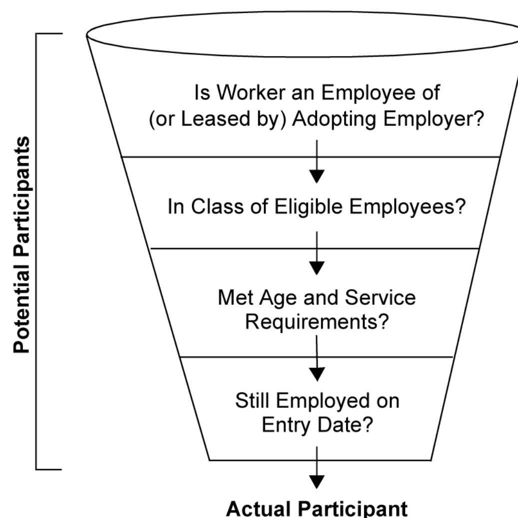
1. Plans May Limit Participation, Within Certain Parameters

Qualified plans do not have to cover all of the employees of the employers that maintain them. Plans can, by design, be more restrictive. While employers have considerable freedom in setting participation criteria, that freedom is not unlimited. The Code and ERISA may affect the plan's ability to filter out potential participants.

This Section VII addresses the process of properly narrowing the universe of individuals who could participate in a 401(k) plan to the group that actually does participate.

2. Four Conditions to Participate

One useful way to view the process of identifying the persons who actually will participate in a plan is to visualize a funnel with a series of filters. The universe of employees who could participate are at the top of the funnel. Each filter is an eligibility criterion that prevents or delays participation by some employees who could be participants. An employee does not become an actual participant until the employee passes through every filter.



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The eligibility filters may be temporary, merely delaying participation until a minimum age, minimum service, or similar requirement has been met. Or they may be based on conditions that are not likely to change unless the person changes jobs, such as whether a person is paid on an hourly or salaried basis or works for a particular subsidiary.

Either way, an employer's ability to set eligibility criteria is subject to legal limits. Some of the legal limits directly affect the design of the eligibility criteria, such as by imposing a limit on the amount of service that can be required to enter the plan. Others will test the end result to make sure that the tax benefits of qualification do not go disproportionately to the highly compensated.[1] Unless all potential participants are allowed to participate immediately, both limit types will need to be taken into account when designing the plan.

Code and ERISA Overlap. The eligibility requirements for qualified retirement plans, including 401(k) plans, are subject to overlapping provisions in the Code and ERISA.*

* A brief history of these overlapping provisions is found in Section III.

The following subsections discuss the four eligibility conditions: subsection B, the limitations on what workers are eligible for 401(k) participation; subsection C, the limitations on how a plan can define what employees are eligible; subsection D, the limitations on age and service requirements; and subsection E, the limitations on plan entry dates. Subsection F explains the service crediting rules, and subsection G explains how those rules apply to rehired employees. Subsection H explains how to correct eligibility errors, subsection I discusses the rule that allows an individual to waive plan participant, and subsection J addresses record retention requirements for eligibility determinations.

B. Eligibility Condition #1: Participation Limited to Common-Law Employees, Partners and Sole Proprietors, Some Leased and Statutory Employees

The Code does not allow just anyone to participate in a qualified plan. First and foremost, the Code states that qualified plans are for the benefit of "employees," which means common-law employees.[2] In addition, the Code treats individual partners and sole proprietors,[3] some leased employees[4] and full-time life insurance salespersons[5] as employees who are eligible to participate in a qualified plan.

1. *Which Workers Are Common-Law Employees?*

Since the general rule is that only common-law employees may participate in a 401(k) plan (or any other qualified plan), as a threshold issue it is important to determine which workers are common-law employees of the plan sponsor and of any other participating employers. Given the multiple ways in which workers offer their services, however, it is not always easy to determine exactly who is a common-law employee. Indeed, some employers have spent millions of dollars litigating that issue.[6]

The test for determining who is a common-law employee was articulated by the Supreme Court in *Nationwide Mutual Insurance Co. v. Darden*, which noted that the key issue was the hiring party's right to control the manner and means by which the work was done.[7] In one revenue ruling, the IRS listed 20 factors to

[1] The numerical tests intended to ensure that a plan's coverage is nondiscriminatory are discussed in detail in Section XIX, but the coverage rules also must be taken into account when determining plan eligibility criteria because they can significantly limit the sponsor's ability to choose what employee groups will actually participate.

[2] Code § 401(a).

[3] Code § 401(c).

[4] Code § 414(n).

[5] Code § 3121(d)(3)(B).

[6] Several significant cases addressing this issue are discussed in subsection C.

[7] *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318, 14 EBC 2625 (1992) identified the following factors: 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. *See also Hillstrom v. Kenefick*, 484 F.3d 519, 40 EBC 1876 (8th Cir. 2007) (ERISA's definition of "employee" is "completely circular," so Supreme Court test regarding employer's right to control "manner and means" of employment determines whether an individual is an employee for ERISA purposes); *Admin. Comm. of Time Warner, Inc. Benefit Plans v. Biscardi*, 25 EBC 2325 (S.D.N.Y. 2000) (even though administrative committee failed to consider *Darden* factors, it reasonably concluded that workers not on payroll were not common-law employees).

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help determine whether an individual qualifies as a common-law "employee" for tax purposes.[7.1] Those factors have subsequently been reorganized into the following three categories, which are described in detail in IRS Publication 15-A (Employer's Supplemental Guide).

- *Behavioral control.* This category focuses on whether the business has a right to direct and control how the worker does the task for which he or she is hired—in particular, the IRS looks at what instructions and training are given by the business to the worker.
- *Financial control.* Under this category, the IRS examines whether the hiring entity has a right to control the business aspects of the worker's job. Relevant factors include the extent to which the worker has unreimbursed business expenses; the extent of the worker's investment; the extent to which the worker makes services available to the market; how the business pays the worker; and the extent to which the worker can realize a profit or loss.
- *Type of relationship.* This category considers what written contracts say about the parties' relationship; whether employee-type benefits are provided; the permanency of the relationship; the type of relationship of the parties; and the extent to which services performed by the worker are a key aspect of the regular business of the company.[8]

The substance of the relationship, not the label, governs the worker's status. Thus, an agreement between the employer and the worker stating that the worker is an independent contractor is only one of many factors that are taken into account and will not control if there is sufficiently contradictory evidence.[9] All of the incidents of the relationship must be assessed. Publication 15-A includes many real-life examples to help employers determine whether an individual is an employee or independent contractor. Helpful hints that employers might use in this regard are also reflected in the detailed questions contained in Form SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding). Employers that want the IRS to make this determination for them can also file this Form with the IRS.

No matter how the factors are articulated, the determination of worker status requires an analysis of all of the facts and circumstances. The IRS factors to be considered are not necessarily equally weighted. (In other words, one cannot simply tally the number of factors indicating an employment relationship and compare it to the number of factors indicating a non-employment relationship.) And no single factor is determinative. In some instances, it will be clear whether a common-law employment relationship exists, while in others, it may be difficult to reach a definitive conclusion, and a cautious approach may be wise.

One complicating factor in this area is that the test for being a common-law employer for benefits plan purposes is different than the rules that apply for other statutory purposes (for example, employment taxes). Thus, a worker may be an employee for some purposes but not others.

> **Looking for More Information About Worker Classification?** For more information about determining who is a common-law employee and who is an independent contractor, including worker classification scenarios, see Section XIV of *Self-Insured Health Plans* (Thomson Reuters/Tax & Accounting, 2012-present, updated quarterly).

2. *Independent Contractors: the Problem of Misclassification*

Whether an individual performing work as an "independent contractor" is really a common-law employee is an issue that arises frequently in today's workplaces. (Other terms used for an independent contractor include consultant, contract worker, or contractor.) The IRS or another federal, state, or local agency may attempt to reclassify these individuals as employees in order to collect employment taxes or provide work-related benefits. And if an agency or court determines that an individual has been misclassified, the next issue often is determining whether they are eligible for plan benefits, possibly retroactively.

In traditional work relationships, an employer can usually distinguish which workers are independent contractors and not common-law employees. For example, the receptionist who is hired to work a fixed number of hours, answer the phone, greet clients in a certain manner, and otherwise respond to direction from the business typically is an employee. By contrast, the carpenter hired to remodel the file room, who

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[7.1] Rev. Rul. 87-41, 1987-1 C.B. 296.

[8] IRS Publication 15-A (Employer's Supplemental Tax Guide). *See also* IRS Publication 15 (Circular E: Employer's Tax Guide) (discussion of IRS and common-law rules for determining employee status); IRS Form SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding) (detailed questions for determining worker status).

[9] IRS Publication 15-A (Employer's Supplemental Tax Guide).

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works unsupervised, provides his own tools, and generally performs the work on weekends when the file room is not being used in connection with the operation of the business is an independent contractor.

But as work relationships have become less traditional, there are those situations where the distinction between an employee and an independent contractor is uncertain, which requires employers to carefully identify which workers are covered under the plan. Sometimes, workers categorized by the employer as independent contractors or consultants actually are common-law employees under the IRS's analysis. As previously noted, it is the substance of the relationship, not the label, that determines the worker's status.[10]

The IRS has long been concerned with "worker misclassification," which relates to the improper classification of employees as independent contractors. The IRS has implemented two initiatives to address worker misclassification. One initiative, implemented jointly with the DOL, was the signing of a memorandum of understanding (MOU) between the IRS and DOL to improve information sharing and collaboration between the two agencies. The MOU states that its purpose is "to reduce the incidence of misclassification of employees as independent contractors, help reduce the tax gap, and improve compliance with federal labor laws."[11] The other initiative was the implementation of a settlement program under which employers can voluntarily reclassify their workers and pay a reduced federal employment tax for past practices.[12]

Voluntary Classification Settlement Program. Under the Voluntary Classification Settlement Program (VCSP), employers can voluntarily reclassify their workers as employees for future tax periods and incur limited federal employment tax liability for the past non-employee treatment.* The IRS has consolidated its VCSP guidance online, with links to applicable FAQs, forms, and other information.† Of course, participating in this program could have implications for a plan sponsor's qualified plans, either in form or operation, and other tax and employment matters.

* IRS Announcement 2011-64, 2011-41 I.R.B. 503, *as modified by* IRS Announcement 2012-45, 2012-51 I.R.B. 724 and IRS Announcement 2012-46, 2012-51 I.R.B. 725.

† IRS Webpage: Voluntary Classification Settlement Program (VCSP), http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Classification-Settlement-Program (as visited June 23, 2016).

With careful plan drafting, an employer generally can avoid extending plan coverage to workers that might later be reclassified. An example of careful drafting is provided in subsection C.

3. Individual Partners and Sole Proprietors

Generally, a partnership or sole proprietorship is permitted to maintain a cash or deferred arrangement, and individual partners or owners are permitted to make deferral elections and otherwise participate in a 401(k) plan.[13]

Section IX discusses the special rules that apply when determining contribution amounts for these self-employed individuals.

4. Professional Employer Organizations (PEOs) and Leased Employees

Determining which workers are common-law employees is particularly difficult when a business (known as the recipient under the leasing rules) acquires the services of workers through a leasing organization, such as a temporary staffing agency. Under a leasing arrangement, the leasing agency providing the workers and the recipient business may share control of the workers. A professional employer organization (PEO), which is a certain type of leasing organization that provides expanded services such as an entire workforce or a management team, presents complex employment and benefit plan issues. PEOs are discussed in Section II. Employers should consult with benefits counsel to determine whether workers provided through PEOs or other leasing arrangements are actually their common-law employees.

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[10] *See* IRS Publication 15-A (Employer's Supplemental Tax Guide) (discussion of employee versus independent contractor status).

[11] Memorandum of Understanding Between the Internal Revenue Service and the U.S. Department of Labor (Sept. 19, 2011), available at http://www.dol.gov/whd/workers/MOU/irs.pdf (as visited June 23, 2016).

[12] IRS Announcement 2011-64, 2011-41 I.R.B. 503 (original), *as modified by* IRS Announcement 2012-45, 2012-51 I.R.B. 724 (relaxing eligibility requirements) *and by* IRS Announcement 2012-46, 2012-51 I.R.B. 725 (creating a temporary program expansion for taxpayers that have not filed all required Form 1099s for reclassified workers).

[13] Code § 401(c); Treas. Reg. § 1.401(k)-1(a)(6).

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The *Microsoft* litigation[14] has created additional uncertainty regarding who is an employee for purposes of plan benefits by holding that a worker may be an employee of both a staffing agency and the recipient organization at the same time. According to the court, the plan sponsor's status as an employer depends on an application of the traditional common-law factors and is not influenced by the worker's employment by another entity. Thus, unrelated entities may be co-employers.[15]

> **Review Potential Co-Employer Status.** Plan sponsors (in the Ninth Circuit, at least) should consider whether they are co-employers of any workers whom they previously assumed were employees of a staffing agency. If so, the plan sponsors either must extend 401(k) plan eligibility to these workers or must expressly exclude them from the plan.*

* How to exclude workers of a staffing agency is discussed in subsection C.

Temporary PEO workers also may be treated as leased employees under Code § 414(n) if they satisfy certain criteria. A leased employee under Code § 414(n) is a worker who provides services to the recipient business under a leasing agreement on a substantially full-time basis for at least a year and is under the "primary direction or control" of the recipient business.[16] Often, workers associated with leasing organizations will not be Code § 414(n) leased employees, however, because they do not work substantially full-time for a year. Subsection C discusses the issues raised when attempting to exclude categories of employees, and subsection F discusses the special service crediting rules for Code § 414(n) leased employees.

> **Note on Terminology: Leased Employees.** The term "leased employee" can be misleading, because a leased employee usually is not a common-law employee of the recipient business.* So the term "leased worker" would be more apt, but this discussion uses the term leased employee for consistency with the Code and regulations.

* *But see Vizcaino v. Microsoft Corp.*, 173 F.3d 713, 23 EBC 1209 (9th Cir. 1999) (suggesting that recipient business may be an employer of leased employees).

Leased employees under Code § 414(n) must be treated as employees for qualified plan purposes, including nondiscrimination testing and service crediting for vesting and eligibility purposes.[17] This means that even though Code § 414(n) leased employees may not qualify as common-law employees, a plan may be required by Code § 414(n) to cover them. The reason a plan may be required to cover the leased employees is that plans must cover a sufficiently broad cross-section of the plan sponsor's workforce to attain the status of a qualified plan and gain the associated tax benefits. If the workforce has a high enough percentage of Code § 414(n) leased employees, and those leased employees are required (for testing purposes) to be treated as regular common-law employees, then excluding the leased employees could cause the plan to fail the minimum coverage requirements.[18] As a result, the recipient business would be required to cover all or a portion of the leased employees under its plan to maintain the plan's qualification.

A plan should expressly exclude Code § 414(n) leased employees if the plan sponsor intends for the plan to exclude them from coverage.[19] Many 401(k) plans expressly exclude Code § 414(n) leased

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

[15] *Vizcaino v. Microsoft Corp.*, 173 F.3d 713, 23 EBC 1209 (9th Cir. 1999). The EEOC has reached the same conclusion as to claims by contingent workers under the Americans with Disabilities Act. EEOC Enforcement Guidance: Application of the ADA to Contingent Workers Placed by Temporary Agencies and Other Staffing Firms, n.11 (Dec. 22, 2000) ("Often, a staffing firm and its client will be joint employers of a staffing firm worker."), available at http://www.eeoc.gov/policy/docs/guidance-contingent.html (as visited June 23, 2016). *See also Burrey v. Pacific Gas & Elec. Co.*, 159 F.3d 388, 22 EBC 1887 (9th Cir. 1998) (analysis must first determine if employees categorized as "leased employees" are actually common-law employees).

[16] Code § 414(n). Section XVIII provides a more detailed discussion of leased employees. *See also* IRS Publication 15-A (Employer's Supplemental Tax Guide) (discussion of leased employees).

[17] The definition of a Code § 414(n) leased employee and details about the requirements under Code § 414(n) are discussed in Section XVIII. The use of the term "leased employee" can be misleading, because a leased employee of an organization receiving that individual's services is not normally a common-law employee of the recipient organization. Code § 414(n)(1). *But see Vizcaino v. Microsoft Corp.*, 173 F.3d 713, 23 EBC 1209 (9th Cir. 1999) (suggesting that recipient organization may be an employer of leased employees); *Burrey v. Pacific Gas & Elec. Co.*, 159 F.3d 388, 22 EBC 1887 (9th Cir. 1998) (remanding to trial court to determine if leased employees were actually common-law employees).

[18] The minimum coverage rules under Code § 410(b) are discussed in Section XIX.

[19] *See* IRS Notice 84-11, 1984-2 C.B. 469, Q/A-16 ("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 employees will be treated under the recipient's plan."). *See also Bronk v. Mountain States Tel. & Tel., Inc.*, 2000 WL 827534 (10th Cir. 2000) (holding no requirement to cover leased workers unless coverage test requires it).

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employees from participating in the plan but provide an exception to extend participation for the rare circumstance when the plan would be required to cover them to pass the coverage test of Code § 410(b).

5. Certain Statutory Employees

Certain full-time life insurance salespersons are considered “statutory” employees for FICA purposes,[20] which means that, although they would not be considered common-law employees under the IRS’s factors, they are nonetheless treated as common-law employees (at least for some purposes) because the Code says so. These statutory employees also are considered employees for purposes of contributions to a qualified plan.[21] A full-time life insurance salesperson is “[a]n individual whose entire principal business activity is devoted to the solicitation of life insurance or annuity contracts, or both, primarily for one life insurance company.”[22]

Full-time life insurance salespersons are employees only for FICA and certain benefit purposes, including participating in a 401(k) plan sponsored by the life insurance company. They receive a Form W-2 from the insurance company, marked to indicate statutory employee status, showing commissions paid and contributions to the 401(k) plan.[23] Their earnings are subject to FICA taxes but are not subject to federal income tax withholding.[24]

Is a Statutory Employee an Employee for All Purposes? Full-time life insurance salespersons are employees only for FICA and certain benefit purposes, including participating in a 401(k) plan sponsored by the life insurance company. They receive a Form W-2 from the insurance company, marked to indicate statutory employee status, showing commissions paid and contributions to the 401(k) plan.

Plans maintained for full-time life insurance salespersons are subject to the tax qualification rules under Code § 401(a) but are not subject to ERISA’s substantive provisions because these statutory employees are not common-law employees.[25] A life insurance company should consult with legal counsel before establishing a plan for this worker category, and consider requesting an IRS ruling as to whether its agents meet the statutory requirements as full-time life insurance salespersons before establishing a 401(k) plan for them.[26] Finally, even though there are other categories of statutory employees for FICA purposes, such as traveling salespersons[27] and certain home-based workers,[28] the Code does not permit their employers to sponsor qualified plans on their behalf.[29]

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20 Code § 3121(d)(3)(B).

21 Code § 7701(a)(20).

22 Treas. Reg. §§ 31.3121(d)-1(d)(3)(ii) and 31.3121(d)-1(d)(4); Rev. Rul. 54-312, 1954-2 C.B. 327. *See also* Priv. Ltr. Rul. 8344046 (July 29, 1983) (agents working simultaneously for three related companies were full-time life insurance agents when no more than 20% of their business went to unrelated companies only after the business was refused by the three related companies).

23 Full-time life insurance persons, who receive a Form W-2 as statutory employees, are still independent contractors who, pursuant to Code § 162(a), can report business income on Form 1040, Schedule C. *See also* IRS Publication 15-A (Employer’s Supplemental Tax Guide) (discussion of statutory employees).

24 Rev. Rul. 90-93, 1990-2 C.B. 33; General Instructions for Forms W-2 and W-3.

25 *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 14 EBC 2625 (1992).

26 *See, e.g.*, Priv. Ltr. Rul. 7807008 (Oct. 28, 1997) (agents were not statutory employees); Tech. Adv. Mem. 7608201890A (Aug. 20, 1976) (full- and part-time selling agents were neither common-law employees of the insurance company nor statutory employees for purposes of Code § 3121(d)(3)(B)).

27 Code § 3121(d)(3)(C).

28 Code § 3121(d)(3)(D).

29 *See also* IRS Publication 15-A (Employer’s Supplemental Tax Guide) (discussion of statutory employees).

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C. Eligibility Condition #2: Participation Limited to Class of Eligible Employees Defined in Plan

A qualified plan is not required to cover all of the employer's employees. This means that the employer can make choices about which categories of employees should receive plan benefits. Remember, however, that a qualified plan must cover a sufficiently broad cross-section of the employer's workforce in order to achieve the status of a qualified plan and to obtain the associated tax benefits. If an employer defines the class of eligible employees too narrowly (that is, structures the plan to exclude too many lower-paid employees), then the plan will fail the Code's minimum coverage requirements and cease to be a qualified plan.[30]

Without going into detail about the Code's minimum coverage requirements, this subsection describes some specific legal pitfalls that employers should attempt to avoid when defining the class of eligible employees. First and foremost, it is critical that clear plan language reflects the employer's design choices; the language is especially important when an employer wishes to exclude certain classes of employees. Moreover, the plan language should be reviewed periodically to ensure that it reflects changing employment practices.

> **Why Would an Employer Want to Exclude Some Employees?** There are a number of reasons why an employer would want to exclude one or more categories of employees from its 401(k) plan. For example, a large company may comprise multiple business units, and one form of plan might be considered common and competitive for a certain category of employees (such as assembly line workers) but not for another category of employees (such as truck drivers). As a result, some employers have different plans for different categories of employees; this structure requires that a plan specifically exclude all applicable categories of employees not entitled to benefits under that plan.

1. *Excluding Part-Time, Temporary, or Seasonal Employees*

a. Service-Based Exclusions

Qualified plans may require individuals to work for a certain length of time before they become eligible, but generally, the longest waiting period a plan can impose is one year: More specifically, for plans that define years of service based on an hours-of-service definition, "one year" means 1,000 hours in a 12-month period.[31] The Code's minimum service rules are discussed in subsection D.

Employers often want to restrict plan participation to the more stable workforce of full-time employees and to exclude part-time employees. An exclusion based on part-time status, however, may conflict with the Code's minimum service rules because part-time status is inherently dependent on the amount of service performed. As a result, if part-time status is based on anticipated or scheduled service and is used as an exclusion, it is possible that the exclusion could impose a higher service-based standard than the Code allows.

If a plan defines part-time employees as employees who have not completed a year of service within the meaning of the Code's minimum service rules, that part-time exclusion would be acceptable because it imposes the same maximum service requirement as the Code. But if a plan were to define part-time employees, for example, as employees who are "regularly scheduled" to work 20 or fewer hours a week, the plan might end up excluding employees who actually work 20 hours a week for 52 weeks and therefore have

[30] The minimum coverage rules under Code § 410(b) are discussed in Section XIX.

[31] Code § 410(a).

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