Employee Benefits & Executive Compensation Update

IN THE SPOTLIGHT

Employers Beware: How Do You Protect Against The Significant Legal Risks Posed By The Use Of Contingent Workers?

Daniel N. Janich

The Wall Street Journal and other media outlets report almost on a daily basis that continued high unemployment and underemployment rates are to continue for a long time to come despite an improved economic picture. This suggests that employers will be slow to hire full time employees even when they have returned to profitability. Cautious companies will likely hire contingent workers who do not present a significant financial long - term commitment, thus allowing for maximum flexibility as economic conditions dictate. However, if companies do not structure the use of contingent workers properly from a legal viewpoint, they could face significant legal and financial risks. Perhaps chief among these risks are costly claims for benefits filed by such workers that could range from a few thousand to millions of dollars, depending on the size of the workforce.

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Who is a Contingent Worker?

Individuals designated as contingent workers, include independent contractors (also known as freelancers), employees leased from a staffing agency (leased employees), seasonal and temporary workers and part-time employees. Frequently these individuals are not readily distinguishable from the company's regular, full-time employees with one major exception; contingent workers are not eligible to participate in the company's employee benefit plans. However, this fact alone has not stopped these workers from attempting to and sometimes being successful in challenging their classification.

Companies as service recipients must structure their relationship with the contingent workforce in such a manner that when either the courts or the IRS investigates it, it is clear that these individuals by virtue of their status are not eligible to receive benefits. Courts have adopted the traditional common-law agency test to ascertain whether a worker qualifies as an "employee" for ERISA purposes. Under this test, "employee" status is examined by determining the extent to which the hiring party retains the right to control the manner and means by which the work is accomplished ("right to control test"). In addition to the right to control test, courts have adopted the use of the *Darden* factors, as articulated by the United States Supreme Courts in *Nationwide Mutual Insurance Co. v. Darden*, where the Court first enunciated what constitutes an "employee" for plan eligibility purposes under ERISA. The following are the *Darden* factors which should be given equal analytical weight: 1) the skill required; 2) the source of the instruments and tools; 3) the location of the work; 4) the duration of the relationship between the parties; 5) whether the hiring party has the right to assign additional projects to the hired party; 6) the extent of the hired party's discretion over when and how long to work; 7) the method of payment; 8) the hired party's role in hiring and

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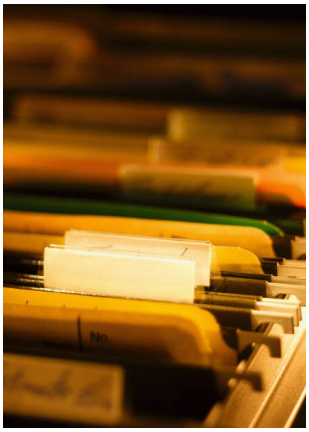

paying assistants; 9) whether the work is part of the regular business of the hiring party; 10) whether the hiring party is in business; 11) the provision of employee benefits; and 12) the tax treatment of the hired party.

The Court in *Darden* did not address how the term "employee" is defined under the Internal Revenue Code. The IRS in its investigations as to whether certain contingent workers should be re-classified as common law employees, has applied the common-law agency test as well, by applying a 20-factor test to assess worker status for purposes of benefit eligibility. The 20 factors identified by the IRS include a consideration of the manner in which the worker is paid, the right to discharge, whether services are made available to others; and the furnishing of tools and materials.

Given that the determination under either test entails a fact-intensive inquiry, service recipients must be prepared to answer how their contingent workers have been treated under the factors enumerated above. The courts frequently encounter situations where the job assignments of contingent workers are no different than that of full time regular employees, and the hiring company exerts or has authority to exert a great deal of supervisory control over the work of such contingent workers. In such cases, the danger of a misclassification and subsequent claim for coverage under a company's benefit plans will certainly be a very real possibility.

***Vizcaino v. Microsoft Corporation*: Independent Contractors**

One of the most important cases in the last dozen years or so to have addressed the issue of worker eligibility for benefits arose in the Ninth Circuit Court of Appeals. In *Vizcaino v. Microsoft Corp.*, freelance workers brought a class action suit under ERISA against Microsoft seeking benefits under its savings and stock purchase plans. Although the workers had signed agreements when hired that described them as "independent contractors" only, their day-to-day work was indistinguishable from Microsoft's permanent full time regular workforce. As a result, the IRS subsequently classified the workers as common-law employees for tax purposes. In the litigation that followed, the Ninth Circuit found that the classification was based on "mutual mistake" thereby rendering the "independent contractor" language entirely meaningless. Notwithstanding a subsequent settlement of this claim for $96.885 million, a legion of similar claims has been asserted and continues to this very day.

Two-Pronged Eligibility Test for Leased Employees

Companies often use the services of leased employees pursuant to agreements with staff leasing agencies. Unless these arrangements strictly comply with the requirements of IRS Code §414(n)(2), there remains a significant risk that the IRS could reclassify such workers as common law employees of the service recipient. Code §414(n)(2) allows for companies to use contingent workers notwithstanding the fact that the service recipient has the right to control and supervise the manner in which the work is to be performed. Section 414(n) (2) describes a narrower class of leased workers as any person who is not an employee of the recipient and who provides services to the recipient where: 1) such services are provided pursuant to an agreement between the recipient and the leasing organization; 2) such person has performed services for the recipient on a substantially full-time basis for a period of at least 1 year; and 3) such services are performed under the primary direction or control of the recipient.

Over time the courts developed a two-pronged analysis of eligibility when addressing whether workers initially classified as "leased employees" were, in fact, entitled to maintain their benefits claim. The first prong is a threshold requirement whereby courts determine whether the claimant is indeed a common law employee or as asserted by the service recipient, a leased employee. Then, if the court determines that the individual is a common law employee, the second prong requires an analysis of the benefit plan's language to ascertain whether the plan expressly excludes the claimant's worker classification. In response to the *Vizcaino* case, employers increasingly began to adopt plan provisions that rendered reclassified contractors ineligible for plan benefits.

Temporary or Seasonal Workers and Part-Timers

Temporary or seasonal workers are, by definition, hired for a limited duration. Such workers may be common law employees hired by the company, or independent contractors or leased employees. The temporary status of such workers generally precludes plan eligibility because they may not satisfy the minimum service requirements of the company plans. If such a worker, however, satisfies the plan's eligibility requirements—as is often the case with part-timers—such worker will be entitled to participate in the plan and thereafter receive plan benefits.

Recommendations on How You Can Minimize Potential Liability Exposure

It should be readily apparent by now that the short term financial benefits of using contingent workers can be easily wiped out by the long-term consequences of doing so. Therefore, what can a company do to minimize its liability exposure in such cases? How can it best defend itself when its worker classification is challenged by those it had considered to be either leased employees or independent contractors? Although such inquiries are almost always fact intensive ones, companies should consider adopting the following defensive measures when using a contingent workforce:

- The company must have written agreements with the independent contractors containing clear language designating their status as contractors, not employees, and describing the consequences of such status: i.e., no eligibility for plan benefits. To ensure that such agreements are to be deemed enforceable knowing waivers of benefits, such workers must be required to sign off on them through written acknowledgements.

- Leased employee arrangements should fall within the requirements of Internal Revenue Code §414(n) to ensure that such workers will not be reclassified as common law employees of the service recipient.

- The specific language of your benefit plans should be reviewed to confirm that it clearly excludes independent contractors and leased employees, including workers who may later be reclassified by any governmental agency as common law employees of the plan sponsor.

- The plan administrator must ensure that any exclusion of season, temporary or part-time workers from plan eligibility complies with the service requirements of the plan. If such workers are likely to satisfy the plan's service eligibility requirements, you must assess whether such workers may be reasonably excluded from eligibility (on some other basis without referenced to the number of hours they typically perform service) as a class without violating the plan's minimum coverage requirements.

- Exercise great care when reclassifying a portion of your regular full time employees as non-employees, whether as independent contractors or leased employees, to ensure consistent with the factors discussed above that they are thereafter treated for all purposes as non-employees, and do not continue performing the same services in the same fashion as they did prior to the reclassification.

- Implement and follow a program that clearly documents and distinguishes the company's regular full time employees from its independent contractors and leased employees with respect to the type of work being performed, how it is performed, what support is provided for performing the work, and how the worker is supervised. Incorporating the factors enumerated above should develop this program.

You will find a more detailed legal analysis of this topic in the chapter I authored

entitled "Contingent Workers and Employee Benefits" which appears in the legal treatise, *ERISA Litigation*, published and updated by the Bureau of National Affairs (BNA).

A copy of this chapter is available for download at http://www.greensfelder.com/publicDocs/DNJ.Chapter.38.pdf

RETIREMENT PLANS

Participant Reactions to Poor Economic Climate

Laura Krebs Al-Shathir

While employers fortunately seem to be noticing signs of a rebounding economy, employees continue to be adversely impacted by the economic downturn – with family members continuing to be out of work or experiencing reduced working hours, depressed home values, and tight credit. As a result, many employers are receiving an increased number of requests from participants to obtain loans or hardship distributions from retirement plans. If your plan does not currently permit participants to receive loans or hardship distributions, your plan may be amended to accommodate participant requests. On the other hand, if your plan already permits participants to obtain loans or hardship distributions, now is a good time to review the applicable rules.

Hardship Distributions

Hardship distributions provide a way for participants to access retirement plan amounts prior to retirement to cover certain expenses, such as costs to pay for medical care, the purchase of a principal residence, tuition, and amounts necessary to prevent the foreclosure or eviction of the participant from his or her home. Employees should be aware, however, that the amount of a hardship distribution is includible in the participant's gross income at the time the distribution is made (to the extent not previously subject to tax), and the amount may also subject to an additional 10% early withdrawal tax.

The following requirements must be satisfied in making a hardship distribution: (a) the plan must permit hardship distributions; (b) the distribution must be made on account of an immediate and heavy financial need of the employee; and (c) the distribution must be limited to amount necessary to meet that need. If these requirements are not satisfied, the plan's qualified status could be at risk.

Before making a hardship distribution, plan administrators should review the terms of the plan to determine: (a) whether the plan allows hardship distributions; (b) the plan's procedures for requesting and making a hardship distribution; (c) the plan's definition of hardship; and (d) any limits on the amount and type of funds that can be distributed for hardship from an employee's accounts.

Plan Loans

If permitted by the plan, a participant may request a loan from a qualified retirement plan as an additional means of accessing retirement plan amounts prior to retirement, but the amount of the loan must ultimately be repaid to the plan. Additionally, the participant may be entitled to an income tax deduction on the interest paid on the loan. Unlike hardship distributions, plan loans may be used for any purpose. A participant is not subject to immediate taxation as a result of the loan, so long as: (a) the loan is evidenced by a legally enforceable agreement; (b) the amount of the loan does not exceed statutory limits; (c) the loan is repaid within 5 years (unless it is a home loan); and (d) the loan has substantially level amortization over the term of the loan with payments not less frequently than quarterly. If such requirements are not satisfied, a participant is treated as receiving the amount of the loan as a distribution, subjecting the amount of the loan to current income inclusion and the additional 10% early withdrawal tax.

Additionally, the plan's qualified status could be jeopardized if the following requirements are not satisfied: (a) loans must be available to all participants and beneficiaries on a reasonably equivalent basis; (b) loans must not be made available to highly compensated employees in an amount greater than the amount available to other employees; (c) loans must be made in accordance with the plan; (d) loans must bear a reasonable rate of interest; and (d) loans must be adequately secured.

Final Minimum Pension Funding Regulations

Heather Hoopingarner Thiel

If you sponsor a defined benefit plan or a money purchase plan, the new IRS funding regulations will impact the way your plan's liabilities and contributions are calculated. They provide guidance on the determination of the funding target, the target normal cost, and the adjusted funding target attainment percentage. However, they will probably create more work for your plan's actuary than they will for you.

The regulations address Code §§430(d), 430(f), 430(g), 430(h)(2), 430(i), and 436 and generally apply to ERISA §§206(g) and 303 which parallel Code §§430 and 436. Multiemployer pension plans are not affected by this guidance. They are effective October 15, 2009 and apply to plan years beginning on or after January 1, 2010.

The regulations are similar to previously issued proposed regulations but reflect some important changes, including:

- permitting plan sponsors to use funding balances to reduce a plan's minimum required contributions for future plan years;
- permitting the use of standing elections with regard to the treatment of funding balances by, for example, authorizing the enrolled actuary to apply the funding balance against the minimum contribution until the minimum is met or the funding balance is used up;
- adjusting a plan's target normal cost for plan-related expenses expected to be paid from plan assets during the plan year and any mandatory employee contributions expected to be made during the plan year; and
- requiring the funding target and the target normal cost to include an amount for future benefits to be paid from the plan.

Also, the regulations give plan sponsors greater ability to elect interest rates that will lower their pension liabilities. Any change in any interest rate election that is made for the first plan year beginning in 2010 is automatically approved, in

accordance with prior, informal IRS guidance. Also, a change in a plan's valuation date or asset valuation method that is made for the first plan year beginning in 2010 is automatically approved.

The IRS is expected to issue additional guidance under §430 at a future date.

RETIREMENT PLANS & EXECUTIVE COMPENSATION

IRS Correction Programs

Heather Hoopingarner Thiel

What shape are your qualified retirement plans in? Do you have concerns about the legal sufficiency of your executive compensation plans but hope no one notices? You are not alone.

Maintaining a benefit plan is a very complicated endeavor. So complicated that almost every plan—at some point or another—experiences a problem. You could try to sweep the problem under the proverbial rug or you could fix the problem.

In recognition of benefit program complexities, the IRS offers two correction programs which enable plan sponsors to fix many common problems with retirement plans and executive compensation plans.

EPCRS

The Employee Plans Compliance Resolution System ("EPCRS") and its predecessors have been around for some time. Plans that are intended to satisfy the requirements of Code §§401(a), 403(a), 403(b), 408(k) or 408(p) but that have not met these requirements can correct most failures under EPCRS and continue to provide tax-favored retirement benefits to their employees.

EPCRS is comprised of three components: the Self-correction Program ("SCP"), the Voluntary Correction Program ("VCP"), and the Audit Closing Agreement Program ("Audit CAP"). A plan sponsor can use SCP to correct insignificant operational failures as well as some significant operational failures without payment of any fee or sanction. Plan sponsors can use VCP to correct qualification failures at any time before audit with payment of a limited fee. The Audit CAP program is used to correct errors discovered while a plan is being audited (or otherwise reviewed by the IRS) and requires payment of a sanction.

The programs generally require submission of a letter of explanation, correction of the error and payment of a fee or sanction (except for SCP). After review by the IRS and completion of the correction, your plan is given a clean bill of health!

§409A Corrections:

The Good News. The IRS has a correction program for plans and arrangements subject to Code §409A. The program permits plan sponsors to correct certain operational failures, including:

- a failure to comply with the Code §409A(a)(2)(B)(i) six-month delay if corrected in the same taxable year or in the taxable year following the year of the failure;
- non-insider failure to defer, impermissible acceleration failure, or excess deferral failure if corrected in the same taxable year or in the taxable year following the year of the failure;
- operational failures involving amounts under the Code §402(g) limit if reported no later than the end of the second taxable year following the year of the failure.

Other operational failures can also be corrected under the program and reported by the end of the second calendar year following the year of the failure with limited tax penalties.

The Bad News. There are no corrections currently available for plan sponsors who did not have §409A-compliant deferred compensation documents in place by December 31, 2008. However, if your document was amended, but was not amended correctly, you may be able to make a clarifying amendment if the documentary error was based on a good faith interpretation of Code §409A. Guidance suggests that amendment is also permissible if the benefits are subject to a substantial risk of forfeiture that does not lapse in the year of amendment. The IRS may extend the correction program to permit documentary compliance, but only if it can do so without creating untenable loopholes.

Finally, if no correction is available for your operational failure, it may need to be reported to the IRS.

RETIREMENT & WELFARE BENEFIT PLANS

Helpful Tips

Kristy J. Wrigley

- *Cycle D Filings*. Don't forget that qualified plans with Employer Identification Numbers ("EINs") ending in 4 or 9 are "Cycle D" plans that should be submitted to the IRS for a determination letter no later than January 31, 2010. While plans are not required to be submitted to the IRS for determination letters, doing so provides several advantages. First, it offers the important assurance that the plan is indeed qualified. Second, plans with favorable determination letters are able to take advantage of EPCRS, discussed above.
- *Form 5500 Reporting Requirements*: The new Schedule C for the Form 5500 is available and must be used with respect to reporting for the 2009 plan year. Schedule C now requires reporting of direct and indirect compensation paid to plan service providers. A Form 5500-SF (Short Form) will also be available for small plans (less than 100 participants), beginning with reporting for the 2009 plan year.
- *Plan Maintenance*. The end of the year is a good time to review plan administration in order to ensure continuing compliance with the terms of the plan, verify that proper procedures are being followed and determine whether future changes should be made. Similarly, plan sponsors should review service provider agreements on a regular basis to determine whether the service provider has been complying with the terms of the agreement and the plan, whether any changes are necessary or whether new service providers should be solicited.
- *Fiduciary Concerns*: While most plan sponsors were extremely conscious of their fiduciary duties to monitor plan investments while the economy was flagging, bear in mind that fiduciaries continue to have the duty to monitor investments during periods of economic success, as well.

- Year-end Reminders.
  - Don't forget that 403(b) plans must have a written plan document in place before the end of the year, and any previously existing plan documents must be amended to comply with the final 403(b) regulations before the end of the year.
  - For qualified retirement plans, bear in mind that plans generally must be amended for the Pension Protection Act of 2006 ("PPA") before the end of this year. PPA made sweeping changes to retirement plans, particularly in the realm of defined benefit plan funding. The Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA") made several technical changes to PPA, including the now-mandatory requirement that plans permit nonspouse rollovers of distributions. In addition, while plan amendments are not required until next year, plans nonetheless should be complying at this time with the Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART Act"). The HEART Act made several changes that impact a retirement plan's treatment of individuals called to active military duty, including provisions regarding differential wage payments, death benefits and qualified reservist distributions.
  - Your company's welfare benefit plans also may be affected by several new laws. Be sure to review your plan operations, documents, summary plan descriptions and employee notification materials to ensure they comply with the following:
    - *ARRA*. The American Recovery and Reinvestment Act of 2009 ("ARRA") implemented changes to COBRA, most notably by temporarily subsidizing the cost to employee's of COBRA continuation coverage. Employees who are involuntarily terminated will continue to be eligible for the subsidy through the end of this year.
    - *HITECH Act*. Also as part of ARRA, the Health Information Technology for Economic and Clinical Health Act ("HITECH Act") made numerous changes to the Health Insurance Portability and Accountability Act (HIPAA). Plans must be sure to comply with these new requirements, such as encrypting electronic PHI and notifying participants of breaches in the security or privacy of their PHI. A failure to do so may subject you to significant civil monetary penalties.
    - *GINA*. The Genetic Information Nondiscrimination Act of 2008 ("GINA") also made changes to HIPAA, particularly by clarifying that PHI includes genetic information relating to a participant or beneficiary.
    - *HEART Act*. The HEART Act, discussed briefly above, also impacts health flexible spending arrangements. Plan sponsors now have the option of permitting qualified reservist distributions of unused health FSA amounts to participants called to active military duty.
    - *Michelle's Law*. Plans that require certification of full-time student status for dependents must now continue to provide coverage for up to one year for dependents who lose full-time student status as a result of taking a medically necessary leave of absence from school.
    - *Mental Health Parity*. Group health plans generally must continue to include the same financial and treatment requirements for mental health and substance abuse benefits as commonly apply to most other medical and surgical benefits.

STAY TUNED…

The House of Representatives passed a health reform bill (H.R. 3962) on November 7, 2009. This bill proposes sweeping changes to the nation's healthcare system, including various components that would impact employee welfare benefit plans. The Senate is currently debating its own version of a health reform bill. We will keep you posted regarding any major developments that are taken with respect to this proposed legislation.

Employee Benefits & Executive Compensation Update is published quarterly to inform our clients and friends of important employee benefits and executive compensation issues that may impact their business operations and employment relationships.

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