V-VI. [Reserved]

VII. Eligibility

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A. The Concept of Eligibility

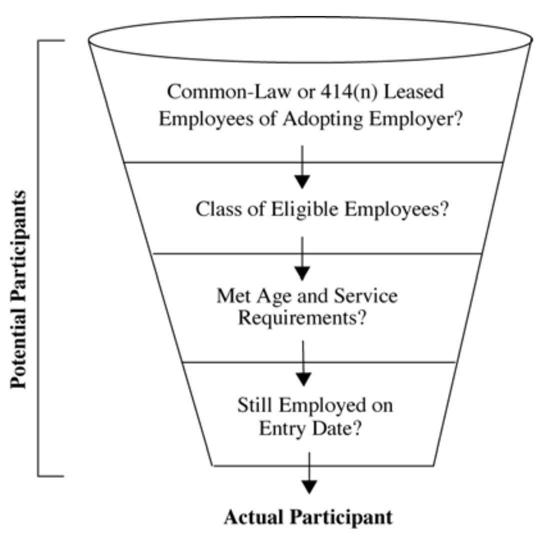
1. Plans May Limit Participation, Within Certain Parameters

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 narrowing down 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 and leased 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.



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 II.

B. Condition #1: Participation Limited to Common-Law Employees, Some Leased Employees, and Certain 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 some leased employees[3] and full-time life insurance salespersons[4] 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. Common-law employee status is determined based on the facts and circumstances using the IRS's "right to control" test and other factors.[5] Specifically, the IRS employs what it refers to as a "20-factor" analysis to determine whether a worker is a common-law employee.[6] The 20-factors include, but are not limited to, the following:

- **Instructions.** A worker who is required to comply with a supervisor's instructions about when, where, and how he or she is to work is ordinarily an employee.
- **Training.** Training a worker by requiring an experienced person to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person for whom the services are performed wants the services performed in a particular manner or method, and that the worker is an employee.
- **Set Hours of Work.** The establishment of set hours of work by the person for whom the services are performed is a factor indicating control and likely indicates that the worker is an employee.
- **Doing Work on Employer's Premises.** If the work is performed on the premises of the person for whom the services are performed, the factor suggests control over the worker, especially if the work could be done elsewhere. The presence of this control suggests that the worker is an employee.[7]

1 The numerical tests intended to ensure that a plan's coverage is nondiscriminatory are discussed in detail in Section XIV, 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 § 414(n).

4 Code § 3121(d)(3)(B).

5 *See Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 14 EBC 2625 (1992) (holding that "employee" for ERISA purposes should be determined using common-law "right to control" and other factors). *See also 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).

6 *See* Rev. Rul. 87-41, 1987-1 C.B. 296 (discussing the "right to control" test and the 20-factors that determine common-law employee status).

7 *See also* IRS Publication 15-A (Employer's Supplemental Tax Guide) (discussion of IRS rules regarding who is an employee and the common-law rules for determining employee status); Form SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding) (detailed questions for determining worker status).

2. *Independent Contractors and Consultants*

Workers who are not a common-law employees will be independent contractors (which can include consultants, contract workers, and other independent workers or agents). In most instances, an employer can distinguish which workers are employees and which are independent contractors. For example, the receptionist who is hired to work a fixed number of hours, answer the phone, and greet clients in a certain manner is an employee. By contrast, the carpenter hired to remodel the file room, who 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.

In those situations where the distinction between an employee and an independent contractor is somewhat blurry, employers should 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 20-factor analysis.[8] With careful plan drafting, employers generally can avoid extending plan coverage to these workers, if that is the employer's intent. An example of careful drafting is provided in subsection C.

3. *Workers Provided Through Leasing Organizations or PEOs*

Determining which workers are common-law employees is particularly difficult when an organization—the recipient—acquires the services of workers through a leasing organization, such as a temporary staffing agency. Under a leasing arrangement, the organization providing the workers and the recipient organization may share control of the workers. A professional employer organization (PEO), which is a type of leasing organization that provides expanded services such as an entire workforce or a management team, presents complex employment and benefit plan issues.[9] Employers should consult with benefits counsel to determine whether workers provided through PEOs or other leasing arrangements are actually their common-law employees.

The Microsoft litigation[10] 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.[11] 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.[12]

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.

4. *Leased Employees Under Code § 414(n)*

Code § 414(n) provides that leased employees who satisfy certain criteria must be treated as employees for qualified plan purposes, including nondiscrimination testing and service crediting for vesting and eligibility purposes.[13] This means that even though Code § 414(n) leased employees may not qualify as

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

9 PEOs are discussed in Section III.

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

11 The impact of this litigation is also discussed in Section III.

12 *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 1, 2006). *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).

13 The definition of a Code § 414(n) leased employee and details about the requirements under Code § 414(n) are discussed in Section XIII. 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 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).

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 employer's workforce to attain the status of a qualified plan and gain the associated tax benefits. If an employer's workforce has a high enough percentage of Code § 414(n) leased employees, and those leased employees are required (for testing purposes) to be viewed as regular common-law employees, then excluding the leased employees could cause the plan to fail the minimum coverage requirements.[14] As a result, the employer would be forced to cover all or a portion of the leased employees under the 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.[15] Many 401(k) plans expressly exclude Code § 414(n) leased employees from participating in the plan, with the common exception to extend participation, if needed, for the plan to pass the coverage test of Code § 410(b).

A leased employee under Code § 414(n) is a worker who provides services to the recipient organization, on a substantially full-time basis for at least a year.[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 D discusses the special service crediting rules for Code § 414(n) leased employees.

5. Certain Statutory Employees

Certain full-time life insurance salespersons are considered "statutory" employees for FICA purposes,[17] which means that although they would not be considered common-law employees under the IRS's 20-factor analysis, 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.[18] 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."[19]

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.[*] Their earnings are subject to FICA taxes but are not subject to federal income tax withholding.[†]

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

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

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14 The minimum coverage rules under Code § 410(b) are discussed in Section XIV.

15 *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 U.S. App. LEXIS 14677 (10th Cir. 2000) (holding no requirement to cover leased workers unless coverage test requires it).

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

17 Code § 3121(d)(3)(B).

18 Code § 7701(a)(20).

19 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 (Jul. 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).

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.[20] A life insurance company should consult with legal counsel before establishing a plan for this worker category and also should 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.[21] Finally, even though there are other categories of statutory employees for FICA purposes, such as traveling salespersons[22] and certain home-based workers,[23] the Code does not permit their employers to sponsor qualified plans on their behalf.[24]

C. 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.[25]

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 the plans specifically exclude the category of employees receiving benefits under another 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, 1,000 hours in a 12-month period.[26] 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 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 defines part-time

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

21 *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)).

22 Code § 3121(d)(3)(C).

23 Code § 3121(d)(3)(D).

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

25 The minimum coverage rules under Code § 410(b) are discussed in Section XIV.

26 Code § 410(a).