Who are Leased Employees & Are They Eligible for my 401(k) Plan?

Facts

I own a small manufacturing company that specializes in office supplies, and I sponsor a 401(k) plan for my employees. One of my former employees, Tim Halpert, worked full-time with me for the past several years but recently left to work for a staffing agency called Prestige Worldwide. Tim was a great employee for many years, and Prestige has offered me the opportunity to have him continue to provide services for me through the staffing agency. Prestige Worldwide also offered the services of another employee, Toby Blenderson, who would work on a part-time basis for about six months.

Question

Do I need to offer the 401(k) plan to Tim or Toby?

Answer

Great question! It is not uncommon for plan sponsors to dismiss workers that come on board via a staffing or employee leasing agency. This is primarily due to the fact that such agencies promote themselves as being the “employer” of these workers. The catch is that there are special rules that apply to so-called “leased employees.”

Since Tim and Toby both work for you via similar arrangements through the same agency, it’s easy to assume at first glance that they would both be treated the same way. While that does seem to make sense, we have to review the specifics of each of their situations against the qualified plan definition of a leased employee to determine how to proceed. If either is determined to be a leased employee, you may need to offer them the opportunity to participate.

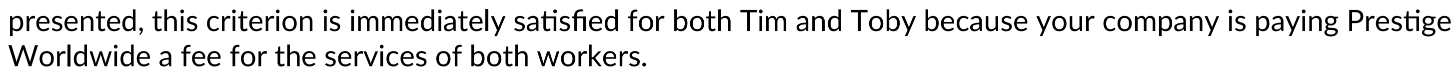
So, how do you determine whether Tim and Toby are considered leased employees? The Tax Code provides guidance via a three-part test. If an individual meets all three of the below requirements with respect to your company, he or she is a leased employee.

- The recipient company pays a fee for the individual’s services;
- The individual performs services for at least one year on a substantially full-time basis (generally, a minimum of 1,500 hours in a 12-month period); and
- The recipient company has primary direction and control over the worker with respect to services rendered.

Let’s take a look at each one in a little more detail.

Fee for Services

This is the most straight-forward of the conditions, and it is exactly what it sounds like. Based on the facts



presented, this criterion is immediately satisfied for both Tim and Toby because your company is paying Prestige Worldwide a fee for the services of both workers.

Substantially Full-Time

It is relatively easy to determine if someone has worked at least 1,500 hours in a 12-month period, so this requirement can also be pretty clear-cut. Tim's prior service as an employee counts. Since the facts note that he worked full-time for several years, he has satisfied the "substantially full time" factor. Toby, on the other hand, does not appear to meet this requirement based on the fact that he will only be working for you for six months.

We should note that the 1,500 hours is based on a regular, full-time work schedule of 2,000 hours per year. For industries in which the normal work schedule varies significantly, the required number of hours necessary to be considered substantially full-time is 75% of whatever the customary full-time schedule happens to be for the industry in question.

Primary Direction and Control

The final part of the test is based on the specific facts and circumstances of the situation, making it more subjective and ambiguous. We've covered this concept in more detail here, but the gist focuses on whether the recipient company controls the "what, where, and when" of the worker's services. For example, if you tell Tim and Toby where and when to show up for work, e.g. your office from 8:30 to 5:00 each day, then you are controlling the where and when. If you specific the tasks they will work on each day and require them to use your office equipment, that also demonstrates that you have primary direction and control. On the other hand, if you simply explain to them what you need as a finished product and leave it to them to work on their own time, using their own equipment, then you likely do not exercise primary direction and control.

Typically, job responsibilities that are common for receptionists, secretaries, and similar office personnel lend themselves to satisfying this requirement. Alternatively, workers such as accountants, engineers, lawyers, etc. who often operate independently and are guided by professional standards usually don't satisfy this part of the test. Although the facts don't go into much detail on this point, it seems unlikely the Tim and Toby would be able to perform services needed in a manufacturing environment on their own time and with their own equipment. Based on that and barring any other relevant details, it appears both Tim and Toby meet this requirement.

Leased or Not?

Based on the above, it looks like Tim Halpert satisfied all three parts of the test and is, therefore, a leased employee. Since Toby Blenderson did not satisfy the second condition, he is not considered a leased employee.

Back to the Question

Now that we've determined the proper classifications for classified Tim and Toby, how do we know if they must be offered the opportunity to participate in the plan? The first order of business is to check your plan document to determine whether it excludes leased employees. If so, Tim should not be allowed to join the plan. If not, then Tim should be offered the plan just like any other employee.

What about Toby? Well, that depends on whether or not Toby is considered to be a true common law employee of Prestige. That takes us back to the question or primary direction and control. If Prestige is not truly Toby's employer and your company exercises that direction and control, it is possible that he is considered to be your employee. In that instance, it doesn't matter if the plan carves out leased employees, because Toby isn't one. If he is your employee, then he should be offered the plan as soon as he meets your regular eligibility requirements. If the waiting period is one year, then Toby will likely be gone before that. However, if your plan otherwise allows new hires to join after only a month, Toby could become eligible.

So, what if you've incorrectly been excluding a leased employee like Tim? We'll give you the bad news first: that would be considered an error that needs to be corrected. Now for the "good" news: because accidentally keeping someone out of a plan is a fairly common mistake (referred to as a Missed Deferral Opportunity failure), the IRS has provided a clear path forward to correction, and we've covered in our Correction of the Quarter column here.

As you can see, it is vitally important that employee/worker classifications are determined accurately and on an ongoing basis. Having knowledgeable service providers (like the DWC team) in your corner can help you navigate situations like these with ease and peace of mind.

Related Resources

- How to Count Employee Length of Service
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