

# IRS Technical Advice Memorandums

## TAM on Section 410—Minimum Participation Standards

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### INTERNAL REVENUE SERVICE

#### National Office Technical Advice Memorandum

Manager, EP Determinations  
Cincinnati, Ohio

#### I. *ISSUES*

1. Whether Plan 1 and Plan 2 may exclude from plan participation employees who are either (1) not reported on the payroll records of affiliated companies as common law employees (even if a court or administrative agency determines that such individuals (even if a court or administrative agency determines that such individuals are common law employees and not independent contractors) or (2) are identified by either a specified job code or work status code on the employer's payroll records, and still satisfy the requirements of section 410(a) of the Internal Revenue Code and section 1.410(a)-3(d) of the Income Tax Regulations.
2. Whether plan eligibility requirements cause Plan 1 and Plan 2 to fail to satisfy the requirement that a plan must be a definite written program.
3. Whether section 11.04 of Plan 1 and sections 11.02, 13.06(e), and 14.02(a) of Plan 2, which provide for an involuntary cashout of a participant's benefit if the present value of the vested portion of such participant's account is \$3,500 or less at the time of the distribution, satisfy the requirement of section 411(a)(11) and section 417(e) of the Code and the regulations thereunder.

#### II. *FACTS*

In September of 1997, the Internal Revenue Service received an Application for Determination for Employee Benefit Plan, Form 5300, for Plans 1 and 2. The Plans were initially effective March 1, 1996, and have calendar plan years. The taxpayer submitted proposed amendments to the plans on March 2, 1998.

Section 2.14 of Plan 1 and section 2.21 of Plan 2, as amended March 2, 1998, state that "an individual shall only be treated as an employee if he or she is reported on the payroll records of an affiliated company as a common law employee. This term does not include any other common law employee or any leased employee. In particular, it is expressly intended that individuals not treated as common law employees by the Affiliated Companies on their payroll records are to be excluded from Plan participation even if a court or administrative agency determines that such individuals are common law employees and not independent contractors." Neither "common law employees" nor "independent contractors" are defined in the Plan document.

Section 3.02 of Plan 2 excludes "special assignment employees" from plan participation. The special assignment classification includes two types of workers: those with job code "Y" (Sections 2.14 and 3.03(a)) and those with work status code "X" (section 3.03(b)). The "X" and "Y" work code dictate how these workers are compensated and other terms of their employment. Specifically, "Y" code workers are hired to perform work on specific contracts with specific deadlines for specific compensation and benefits. These benefits include participation in other employer retirement plans. "X" code workers are members of the salaried employee union who have been laid off and are on the inactive seniority list. Pursuant to an agreement between the union and the employer, these former employees

are hired for a predetermined period of time to complete a specific task or project. The agreement further provides that they be paid the prevailing contract salary rate and that they are not entitled to participate in the employer's retirement plans.

Section 11.04(a) of Plan 1 as amended March 2, 1998, provides in general that upon a participant's retirement or termination of employment, if the present value of the vested portion of the participant's account is \$3,500 or less at the time of the distribution, the vested portion will be distributed to him as soon as practicable following the next valuation date after retirement or termination occurs.

Section 11.02 of Plan 2 as amended March 2, 1998, provides that in the event a participant becomes a terminated participant, if the total value of his or her vested account is \$3,500 or less at the time of the annuity starting date, he or she will receive a total distribution of his or her account as soon as practicable.

Section 13.06(e) of Plan 2 as amended March 2, 1998, provides that with respect to a participant who has an outstanding loan balance at the time he or she terminates employment with the affiliated companies or dies and whose vested account and outstanding loan balance does not exceed \$3,500 on the annuity starting date, the outstanding loan balance will be treated as a distribution.

Section 14.02(a) of Plan 2 as amended March 2, 1998, provides that if the total value of the deceased participant's account is \$3,500 or less on the annuity starting date, a total distribution shall be made automatically to the designated beneficiary.

### III. LAW AND RATIONALE

#### *Issue 1. Section 410(a) Requirements*

Section 410(a) of the Code provides, in general, that a trust will not qualify under section 401(a) if the plan of which it is a part requires, as a condition of participation, that an employee complete a period of service with the employer or employers maintaining the plan extending beyond the later of the date on which the employee attains the age of 21; or the date on which he completes 1 year of service (or two years of service in the case of a plan that meets 410(a)(1)(B)(1)).

Section 1.410(a)-3(d) of the Income Tax Regulations states that "Section 410(a) and section 1.410(a)-4 relate solely to age and service conditions and do not preclude a plan from establishing conditions, other than conditions relating to age or service, which must be satisfied by plan participants. For example, such provisions would not preclude a qualified plan from requiring, as a condition of participation, that an employee be employed within a specific job classification."

Section 1.410(a)-3(a)(1) of the regulations, however, provides that "plan provisions may be treated as imposing age and service requirements even though the provisions do not specifically refer to age or service. Plan provisions which have the effect of imposing an age and service requirement with the employer or employers maintaining the plan will be treated as if they imposed an age or service requirement."

Section 1.401-1(a)(2) of the regulations provides, in relevant part, that a qualified pension, profit sharing, or stock bonus plan is a definite written program and arrangement which is communicated to the employees and which is established and maintained by the employer.

Revenue Ruling 74-466, 1974-2 C.B. 131, holds that a plan which excludes nonsalaried employees unless such employees satisfy alternative eligibility requirements "approved by the trustees" that are not defined or described in the plan fails to satisfy the qualification requirement that a plan have a definite written program and arrangement as described in section 1.401-1(a)(2) of the regulations.

It is important to address these plan provisions in the context in which they arise. Many plans simply state that

employees are eligible to participate, or that common law employees are eligible to participate. These provisions mean the same thing<sup>1</sup>. In *National Mutual Ins. Co. v. Darden*, 503 U.S. 318 (1992), the Supreme Court held that, for purposes of the employee Retirement Income Security Act of 1974 (ERISA), common law agency principles are applied in determining whether an individual is an employee. The Court did not address how the term “employee” is defined under the Internal Revenue Code. However, the same common law standard is applied for Code purposes. Section 3121(d) of the Code and section 31.3121(d)-f(c)(2) of the Employment Tax Regulations provide that an employee includes any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The analysis of a common law employment relationship typically arises in the context of determining whether an individual is a common law employee or an Independent contractor for purposes of employment taxes. This analysis is equally applicable in determining whether an individual is a common law employee of the employer for purposes of section 401(a) of the Code. See *Professional & Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225, 231 (1987); *Edward L. Burnette, O.D., P.A. v. Commissioner*, 68 T.C. 387, 397 (1977); *Packard v. Commissioner*, 63 T.C. 621, 629 (1975).

Determining whether a particular worker is an independent contractor or an employee can be difficult, for its based on facts and circumstances<sup>2</sup>. The entity that engages a worker typically makes the initial determination of whether a worker is an independent contractor or a common law employee. However, that initial determination of a worker’s status can subsequently be determined (by the entity, the Internal Revenue Service, or the courts) to have been erroneous, so that workers who were initially treated as independent contractors are retroactively reclassified as common law employees. This reclassification could have a direct affect upon whether the reclassified workers are eligible to participate in any employee benefit plans of the employer. However, plan participation does not flow automatically from reclassification. Instead, plan terms must be examined to determine whether or not the recharacterized workers participate in the plan.

*Vizcaino v. Microsoft Corp.*, 97 F.3d 1187 (9th Cir. 1996), illustrates how retroactive reclassifications can affect participation in qualified retirement plans<sup>3</sup>. The *Vizcaino* decision involves workers who were initially classified as independent contractors but were later determined to be common law employees for employment tax purposes. The workers claimed benefits under Microsoft’s benefit plans, including its plan containing a cash or deferred arrangement described in section 401(k) of the Code (401(k) plan). The 401(k) plan limited participation to employees on Microsoft’s U.S. payroll. The court concluded that the workers at issue were common law employees and thus were eligible, under the plan’s terms, to participate in the 401(k) plan<sup>4</sup>.

Many employers have amended their retirement plans in the wake of this decision in an attempt to protect their plans against the uncertainty that may be created by retroactive determinations that workers are employees rather than independent contractor. Typically, such amendments provide that workers engaged as independent contractors, or workers not paid through the payroll system will not be eligible to participate in the plan, even if the classification as an independent contractor is later determined to be erroneous.

Section 410(a) of the Code precludes an employer from limiting participation on the basis of age or service, except as specifically permitted in that section. Section 410(a) does not otherwise limit an employer’s ability to design its retirement plan to exclude (or to cover) whichever classifications of employees that it chooses to exclude (or to cover). Similarly, section 1.410(a)-3(d) of the regulations does not preclude an employer from excluding workers based on conditions other than conditions that are age or service related. Indeed, this provision permits an employer to condition participation on “those employees being employed thin a specification job classification.” The section 410(a) inquiry ends with a determination that the plan’s exclusion is not age or service related<sup>5</sup>.

As indicated previously, employers have legitimate reasons to exclude from plans workers who were not engaged as common law employees. If the worker is in fact, an Independent contractor, the employer would be precluded from covering the individual under its plan, absent some specific statutory rule, such as the individual’s status as a based employee under section 414(n) of the Code. Even if the worker is not, in fact, an independent contractor, the employer has a legitimate business interest in knowing the cost of the worker’s compensation package at the time the worker is engaged.

A tax-qualified retirement plan that conditions participation on status as a common law employee need not define that term, for the standard articulated in *Darden* will be applicable absent some special definition in the plan. With respect to the case at issue, section 410(a) of the Code does not preclude a qualified plan from excluding retroactively reclassified employees from participating in the plan. A worker's status is based on facts and circumstances. Making a determination as to whether a common law employment relationship exists is not always straightforward. An employer, making the initial classification of a worker's status, has legitimate concerns in protecting its plan from the consequences of retroactive reclassifications if a mistake is made. Nothing in section 410(a) prevents an employer from addressing these concerns through preventative measures similar to the plan language provided by the taxpayer.

The District contends that the plan language excluding workers identified by work codes in the taxpayer's payer records does not satisfy the requirements of section 410(a) of the Code for the same reasons that plan language excluding independent contractors fails to satisfy section 410(a). We disagree with this argument that plan language excluding independent contractors fails to satisfy section 410(a). As stated earlier, independent contractors are generally precluded from participating in the plan of an employer based on the exclusive benefit rule described in section 401(a). Section 410(a) provides, in part, that a trust shall not constitute a qualified trust if the plan requires as a condition of participation in the plan that an employee complete a period of service with the employer extending beyond the later of the date that the employee attains age 21 or the date the employee completes one year of service. Independent contractors are not employees (except of themselves) and, thus, the section 410(a) minimum age and service conditions are irrelevant for purposes of determining whether independent contractors can be excluded from a qualified plan of an entity that engages them.

Here the plan excludes workers based on a payroll code. Such an exclusion could potentially be an indirect age or service exclusion, and hence impermissible. This question cannot be answered merely by examining the plan document. Instead, an examination of facts external to the plan document would be necessary to conclude that the plan improperly excluded employees based on age or service. As we previously indicated, there are no facts present to indicate that this plan provision, excluding workers by codes, violates section 410(a) of the Code. Consequently, this exclusion does not violate section 410(a).

#### *Issue 2, Definite Written Program Requirement*

The District contends that the definite written program requirement is not satisfied because there is no specific, objective criteria in the plan identifying common law employees and further, that allowing the employer to define an individual as an employee only if the employee is reported on the payroll records of an affiliated company gives the employer discretion in determining who can participate in the plan by specifying how they are paid, i.e., on the payroll or by some other method such as accounts payable. Basically, the District presents the same contention as under section 410 of the Code with respect to the plan's exclusion of independent contractors, namely, that it is not possible to determine from the plan document which employees will participate in the plan.

We believe that, for the same reasons that we discussed with reference to section 410(a) of the Code, the definite written program requirement is not violated by the exclusion of workers who were engaged as independent contractors but later determined to be employees. Although it can be difficult to determine accurately whether a worker is an independent contractor or an employee, the terms have independent legal significance. Further, the reference to the payroll system is in no sense ambiguous. Given the plan language, workers, whether engaged as employees on the payroll or in some other status, can determine whether they are covered by the plan. So too can the employer, trustees, and plan administrator.

As we have indicated, we believe that a plan must be definite as to which workers are covered and which workers are not and that the employer must communicate this essential fact to the employees. We agree with the District that the plan terms cannot leave the determination of which employees are covered to the employer's discretion and that section 1.401-1(a)(2) of the regulations would be violated by plan provisions that permitted such discretion. Clearly, an employee should be able to enforce his or her rights based on the written plan document, and a plan that is not definite enough to enable an employee to determine coverage status so as to enforce rights is fatally flawed.

Section 402(a)(1) of ERISA has a comparable requirement that retirement plans “be established and maintained pursuant to a written agreement.” The ERISA conference report in explaining this requirement stated that a written plan is to be required in order that every employee may, on examining the plan document, determine exactly what his rights and obligations are under the plan. A written plan is required so the employees may know who is responsible for operating the plan. Conference Report 93-1260(1974), reprinted in 1974-3 C.B. 415. We believe that this ERISA requirement is a corollary to the Code requirement of a definite written program that has long been required of a tax-qualified retirement plan. This requirement first appeared in Reg. 103, Sec. 19. 1655(a)(1)-1(a), which was added by T.D. 5278, for taxable years beginning after December 31, 1941.

A plan does not fail this requirement simply because facts extrinsic to the plan document need to be examined to determine which workers are covered by the plan. For example, if a plan covers certain classifications of employees, facts and circumstances must be examined to determine whether a particular worker fits into the covered classifications.

The Code contains pension plan rules that are premised on the fact that plans may cover particular classifications of employees. There are rules that recognize that a plan may cover collectively bargained employees or non-collectively bargained employees in section 410(b)(3) and section 413(b). Also, section 410(b)(2)(A) recognizes that a plan may benefit “such employees as qualify under a classification set up by the employer.”

Further, section 1.410(a)-3(d) of the regulations recognizes that a plan may limit its coverage to specified job classifications.

The Service has published revenue rulings describing situations in which qualified plans covered only certain classifications of employees. This limited coverage was not raised as an issue involving impermissible discretion. In Rev. Rul. 70-384, 1970-2 C.B. 87, the plan covered only supervisors. In Rev. Rul. 74-256, 1974-1 C.B. 94, the plan covered salaried employees in contrast to hourly employees. In Rev. Rul. 70-283, 1970-2 CR. 26, the plan covered nonunion employees.

Just because a plan can cover a particular category of employees and because it is permissible for an employer, in the exercise of its business judgment, to assign a worker to a particular category, does not mean that every category set forth in a plan is acceptable. We disagree with the taxpayer’s suggestion that no further inquiry appropriate. A category like the impermissible category discussed in Rev. Rul. 74-466, 1974-2 C.B. 131, (employees approved by the trustees), is not acceptable. There may be other categories that leave the employer arbitrary and unbridled discretion and that are based on no independent business reason such that the category does not satisfy the definite written program requirement. For example, if the plan said that it covered employees who were on a list and there was no business reason for the list and a particular worker could be added to or removed from the list by the employer at any time, then an argument could be made that such a plan provision fails the definite written program requirement. We do not now suggest that such an argument be raised. We believe such a plan provision would be unusual and that a plan that meets the test below will be acceptable.

We believe the appropriate inquiry as to whether or not a particular category is acceptable is whether, given the particular facts of the employer and the plan provision, is it clear whether or not a particular employee is or is not in the plan. That is, is it clearly understood by the employees, the plan administrator, and the plan fiduciaries when they examine all the facts, which employees are covered by the plan and which employees are excluded. If this question can be answered in the affirmative, then the plan passes the definite written program requirement. Whether the question is being asked as to the present situation or is being asked on a retrospect basis, the test is the same. Thus, what is definite today should be definite tomorrow and the same answer should obtain with respect to a particular worker. On the other hand, if given knowledge of the same facts a reasonable person would not be able to tell who was covered or who was excluded, then the plan fails the test. Similarly, if the answer can change with respect to a particular employee when the question is asked on a retrospective basis, the classification is suspect.

We now turn to the facts in this case to see if the use of work and job codes in the context of the employer’s business

satisfies the definite written program requirement The “X” code workers that are excluded are basically rehired union employees who are on an inactive seniority list The “Y” code workers that are excluded are hired to work on specific contracts and have a different compensation package, including coverage in another retirement plan. Here, the excluded workers know who they are. Further, it is undisputed that if any person looked at the facts with respect to a particular worker that person would know if the worker fit within the enumerated categories. Nor is there any question that at a subsequent time, an employee could be retroactively determined to have been a member of these excluded classes. Further, the employer has demonstrated that there is a business purpose for these categories. For these reasons, we believe that the plans satisfy the definite written program requirement.

### *Issue 3. Cash-Out Requirements*

Prior to the enactment of the Taxpayer Relief Act of 1997 (TRA’97), section 411(a)(11)(A) of the Code provided that if the present value of any nonforfeitable accrued benefit exceeded \$3,500, a plan met the requirements of section 411(a)(11) only if such plan provided that such benefit could not be immediately distributed without the consent of the participant. TRA’97 changed this cash-out limit to \$5,000, effective for plan years beginning after August 5, 1997.

Interpreting the law prior to the enactment of TRA ‘97, section 1.411(a)-11(c)(3) of the regulations provides that the written consent of a participant is required before the commencement of the distribution of any portion of the participant’s accrued benefit if the present value of the nonforfeitable total accrued benefit is greater than \$3,500. If the present value does not exceed \$3,500, the consent requirements are deemed satisfied, and the plan may distribute such portion to the participant as a single sum. The regulation further provides that, if the present value determined at the time of a distribution to the participant exceeds \$3,500, then the present value at any subsequent time is deemed to exceed \$3500; this is commonly referred to as the “lookback rule.”

Section 1.417(e)1(b)(2) of the regulations provides that written consent of the participant and, if the participant is married at the annuity starting date and the benefit is to be paid in a form other than a qualified joint and survivor annuity (QJSA), the participant’s spouse (or if either the participant or the spouse has died, the survivor) is required before the commencement of the distribution of any part of an accrued benefit if the present value of the nonforfeitable benefit is greater than \$3500. No consent is required before the annuity starting date if the present value of the nonforfeitable benefit is not more than \$3,600. If the present value of the accrued benefit at the time at any distribution exceeds \$3,500, the present value of the accrued benefit at any subsequent time will be deemed to exceed \$3,500.

Effective December 31, 1998, final and temporary regulations were published under Code sections 411(a)(7), 411(a)(11) and 417(e)(1). These regulations provide guidance relating to the increase from \$3500 to \$5,000 of the limit on distributions from qualified retirement plans that can be made without participant consent. This increase is contained in TRA’97.

In addition, these regulations eliminate, for most distributions, the “lookback rule” pursuant to which the qualified plan benefits of certain participants are deemed to exceed this limit on mandatory distributions.

In determining whether a participant’s nonforfeitable accrued benefit may be distributed without consent during plan years beginning on or after August 6, 1997, the now cash-out limit of \$5,000 is permitted to be applied as though it were in effect for an plan years, including those beginning before August 6, 1997. In addition, these temporary regulations eliminate for many distributions, the “lookback rule” under section 1.411(a)-11(c)(3) of the regulations. Under these regulations, a plan may provide that the present value of a participant’s nonforfeitable accrued benefit may be distributed without consent if that present value does not exceed the cash-out limit as determined at the time of the current distribution without regard to the present value of the participant’s benefit at the time of an earlier distribution. However, section 1.411(a)-11T(c)(3)(1) of the temporary regulations, which in effect, eliminates the “lookback rule,” applies only to distributions made on or after March 22, 1999.

In this case, the plan amendment fails to satisfy section 1.411(a) 11(c)(3) of the regulations which applies to

distributions made on or before March 22, 1999. Thus, the plan provisions in section 11.04 relating so mandatory distributions that do not require employee consent fail to satisfy section 411(a)(11)(A) of the Code for the period from the effective date of the amendment of March 2, 1998 through March 21, 1999.

#### IV. CONCLUSIONS

1. We conclude that Plans 1 and 2 may exclude from plan participation employees who are either (1) not reported on the payroll records of affiliated companies as common law employees (even if a court or administrative agency determines that such individuals are common law employees and not independent contractors) or (2) are identified by either a specified job code work status code on the employer's payroll records, and still satisfy the requirements of section 410(a) of the Internal Revenue Code and section 1.410(a)-3(d) of the Income Tax Regulations.
2. We further conclude that the eligibility provisions of Plan 1 and Plan 2 do not prevent each Plan from satisfying the requirement that a plan must be a definite written program.
3. Section 11.04 of Plan 1, and sections 11.02, 13.06, and 14.02 of Plan 2 as provided in the proposed amendments of March 2, 1998, fail to satisfy the requirements of section 411(a)(11) of the Code and sections 1.411(a)-11(c)(3) of the Income Tax Regulations for the period from March 2, 1998 through March 21, 1999.

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<sup>1</sup>The term "employee," as used in a qualified plan, may include certain individuals who are not common law employees. For example, an independent contractor may be treated as an employee with respect to a plan established by the independent contractor by reason of section 401(c) of the Code. Similarly, a full-time life insurance salesman is treated as an employee for qualified plan purposes. These statutory expansions of the term are not relevant for purposes of this technical advice memorandum.

<sup>2</sup>Revenue Ruling 87-41, 1987-1 C.B. 296, contains a list of twenty factors courts had applied in determining whether a common law employment relationship exists. However, in order to better reflect the factors courts now appear to consider relevant, the Internal Revenue Service now makes this determination by exploring three primary categories of evidence: behavioral control, financial control, and relationship of the parties.

<sup>3</sup>The discussion of this case is, of course, based solely on published court opinions.

<sup>4</sup>The court remanded the case for a "determination of any questions of individual eligibility for benefits that may remain following issuance of this opinion and for calculation of the damages or benefits due the various class members." *Vizcaino V. Microsoft Corp.* 97 F.3d 1187, 1200 (9th Cir. 1996), *aff'd*, 120 F.3d 1006 (9th Cir. 1997). See also *Vizcaino V. Microsoft Corp.* 173 F.3d 713 (9th Cir. 1999).

<sup>5</sup>Exclusions permitted under section 410(a) may cause a plan to fail to meet the coverage standards of section 410(b). The latter is a separate Inquiry, which is not at issue in this case.