

## Employee Benefits Alert: Another 401(k) Headache: Covering Leased Employees

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In a recent employee benefits alert, we looked at temporary and part-time employees, and the circumstances under which an employer must cover them under its 401(k) plan. This article focuses on another worrisome coverage issue that often confronts 401(k) plan sponsors: when to cover leased employees.

**Client Concerns.** Clients often ask us whether employees who are hired through a staffing agency or leasing organization must participate in their 401(k) plan, or must be counted for testing purposes. The answer is complicated and requires careful analysis by the employer. If leased employees were mistakenly excluded from an employer's 401(k) plan, the employer must correct the error or risk plan disqualification.

**Always Check the Plan Document.** The first step in understanding whether leased employees must be covered is to check the terms of the 401(k) plan document. Most third-party administrator prototype plan documents already contain optional language excluding leased employees from participation; to do so, all the employer has to do is check a box. Documents that don't contain such language already can usually be amended to exclude leased employees. However, not all plan providers explain to employers the importance of excluding leased employees, or the consequences of not doing so.

An employer who has failed to exclude leased employees from its plan may have to make expensive, time-consuming corrective contributions on behalf of leased employees, or risk plan disqualification. Such an employer will also want to give serious consideration to amending its plan to exclude leased employees in the future.

### Who is a Leased Employee Under Code Section 414(n)?

A three-part test determines whether an individual is considered a "leased employee" under Internal Revenue Code Section 414(n), such that he or she must be treated as an employee of the recipient employer.

- First, the individual must be hired pursuant to an agreement between the company sponsoring the 401(k) plan and the leasing organization.

- Second, the individual must perform services under the primary direction and control of the company sponsoring the 401(k) plan.
- Third, the individual must work on a substantially full-time basis for at least one year. (There are different interpretations of what "a substantially full-time basis" means, but one easy rule of thumb is to count individuals who work 1,000 or more hours in a year).

If all three parts of this test are satisfied, then the individual in question is considered to be a leased employee under Code Section 414(n). If the 401(k) plan document does not exclude leased employee, the individual must generally be allowed to participate in the plan.

### Even if a Plan Document Excludes Leased Employees, the Employer May Still Have to Count them for Coverage Testing.

Under certain circumstances, an employer may still have to count Code Section 414(n) leased employees for purposes of performing its 401(k) minimum coverage test, even if the plan has already been drafted to exclude leased employees from actual participation.

To analyze this problem, the employer must ask two questions:

- Do leased employees constitute 20% OR LESS of its workforce,  
AND
- Are those leased employees covered by a "safe harbor money purchase plan" maintained by the leasing organization? (such a plan provides a 10% contribution, immediate participation, and full and immediate vesting; in practice, few leasing organizations actually sponsor such a plan).

If the answer to BOTH questions is "yes," then the analysis stops. The employer is eligible for a "safe harbor" exemption, and is not required to count these leased employees in performing its minimum coverage test. Assuming the employer's plan has already been drafted to exclude leased employees, the employer has no further 401(k) obligation with respect to them.

However, if the answer to EITHER question is “no,” the employer must count the leased employees in performing its minimum coverage test – regardless of what the plan says. If the 401(k) plan passes the test, the employer is in the clear. However, if the plan flunks the test (because the employer has a relatively large leased employee population, which is not covered by a leasing agency safe harbor plan) then the employer must cover leased employees in order for the plan to pass coverage.

### **What Should Employers Do?**

(1) Employers should carefully examine their 401(k) plan documents and adoption agreements. They should determine whether or not they employ individuals who are leased employees, and if they do, whether such employees are excluded from participation under the terms of the plan. If they are not, the employer should consider whether it wishes to amend the plan to exclude leased employees on a prospective basis.

(2) If the terms of the plan do not exclude leased employees, but the plan has been excluding leased employees in operation, the employer should determine which leased employees are eligible for a corrective contribution. The employer should review all service records pertaining to such individuals, and work with the leasing organization and the plan’s third-party administrator to make a corrective contribution to the 401(k) plan on their behalf. The cooperation of the leasing organization is crucial, because the amount of an employer corrective contribution can be offset by contributions made to a qualified plan of the leasing organization – even if such plan is not a “safe harbor” money purchase plan. The employer should also determine whether the plan’s coverage tests need to be re-run to account for leased employees.

The employer should also implement policies and procedures to ensure that eligible employees are not excluded from the plan in the future.

Example. Suppose that a leased employee was erroneously excluded from an employer’s plan for a period of one year. The employer will have to make a corrective contribution to the 401(k) plan to “make the employee whole” for the lost opportunity to make salary deferral contributions. The leased employee earned \$40,000 in compensation in the year in question, so he or she is considered a “non-highly compensated” employee under the Internal Revenue Code.

The employer should take the “average deferral percentage” (“ADP”) under the plan for non-highly compensated employees as a group, and multiply that percentage by the employee’s salary. Assuming that the most recent ADP for non-highly compensated employees was 5%, the result would be \$2,000. Then, following IRS guidelines, the employer should contribute 50% of that amount, or \$1,000 to the plan on behalf of the employee. Interest and earnings on the \$1,000 amount should also be contributed to the plan, as well as a separate contribution for missed employer matching contributions and earnings, if applicable. With the assistance of counsel, the employer should determine whether a filing with the IRS is required, or whether the exclusion of this leased employee is eligible for “self-correction” without a filing under applicable IRS rules.

**For more information, contact Mona Clee of the Employee Benefits Group at (650) 335-7806.**

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