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David A. Channer

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COMMENTS

Internal Revenue Code Section 414(n): Congressional Authorization to Discriminate Among Retirement Plan Participants

I. Introduction: Employee Leasing

Congress recently enacted major legislation[1] that revolutionizes rules governing qualified retirement plans.[2] Most retirement plans must be amended to conform with these requirements or they will lose their qualified status. However, some entrepreneurs believe that retirement plan requirements established by the Employee Retirement Income Security Act (ERISA)[3] and subsequent amendments may be circumvented by using employee leasing.

The concept of employee leasing is relatively simple. Under mutual agreement, an employer terminates its non-key employees. The employees are then transferred to an independent leasing company. The leasing organization, which specializes in managing and supplying leased workers to businesses, immediately leases the employees back, under contract, to their original employer (the subscriber). The leasing organization usually

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1. *See* Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426 (codified as amended in scattered sections of 26 and 29 U.S.C.); Deficit Reduction Act of 1984 (Division A—Tax Reform Act of 1984), Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of 26 U.S.C.); Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 and 42 U.S.C.).

2. "Qualified" plans are those retirement plans that satisfy the requirements of I.R.C. § 401 (Prentice-Hall 1985) and treasury regulations thereunder. Qualification results in several tax advantages: (1) contributions made by the employer to the plan are deductible as a business expense; (2) investment income on employer contributions accumulates tax deferred until benefits are paid out; and (3) contributions made by the employer on behalf of employees are not recognized by tha employee for income tax purposes.

3. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 26 and 29 U.S.C.).

maintains exclusive control over the employees but acts for the most part according to the subscriber's desires.

While this strategy relieves employers of the "administrative burdens and costs of maintaining a staff,"[4] the principal reason for using leased employees is to allow the subscriber to establish a qualified retirement plan for his exclusive benefit. This discriminatory result is a blatant violation of ERISA requirements in other situations. Employee leasing is possible because of broad safe harbor provisions contained in section 414(n) of the Internal Revenue Code, which states that a subscriber must treat a leased employee as his own for purposes of retirement plan requirements.[5]

This comment maintains that the language and effect of section 414(n) is inconsistent with its purpose of prohibiting discrimination among retirement plan participants. Instead of preventing circumvention of retirement plan rules, section 414(n) authorizes the practice. Recent amendments to section 414(n) intended to correct the loopholes created by the original statute still have not corrected the problem. This comment proposes additional amendments to section 414(n) that will implement Congress's purpose in enacting that section. Finally, it argues that even if section 414(n) is not amended, employee leasing schemes should be avoided because they subject the subscriber to unacceptable tax risks.

II. Background of I.R.C. Section 414(n)

Employee leasing law prior to section 414(n) was developed in several key Revenue Rulings[6] and cases.[7] These rulings and cases generally applied three principles to determine whether an employer-employee relationship existed. First, in determining who is the "true" employer, one must look to traditional common law guidelines.[8] These guidelines may be summarized as follows:

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4. English, *Leasing Employees—An Idea Catches On,* U.S. News & World Rep., Aug. 27, 1984, at 63.

5. I.R.C. § 414(n) (Prentice-Hall 1985).

6. *See* Rev. Rul. 68-303, 1968-1 C.B. 165, *republication revoked by* G.C.M. No. 39083, Dec. 1, 1983 (revoking the republication of Rev. Rul. 68-303 since I.R.C. § 414(n) covers the situation); Rev. Rul. 75-35, 1975-1 C.B. 131, *declared obsolete by* Rev. Rul. 81-105, 1981-1 C.B. 256; Rev. Rul. 75-41, 1975-1 C.B. 323.

7. *See, e.g.,* Burnetta, O.D., P.A., v. Comm'r, 68 T.C. 387 (1977); Packard v. Comm'r, 63 T.C. 621 (1975).

8. Burnetta, O.D., P.A., v. Comm'r, 68 T.C. 387, 397 (1977); Packard v. Comm'r, 63

> Generally [an employer-employee] relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. . . . In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer.[9]

Second, a "contractual arrangement will not be determinative of [the employer-employee relationship] where the realities of the situation contradict the terms of the contract."[10] Third, "in determining who is an employee under specific circumstances, it is the total factual situation that controls."[11]

Thus, prior to section 414(n) workers were treated as common law employees of the entity that exercised certain key powers, *constructively*, by language contained in the contract agreement, or *actually*, despite contractual language to the contrary. Pre-section 414(n) cases and rulings focused on the following rights in determining the existence of the employer-employee relationship: the right to recruit, test, hire, train, pay, direct work, evaluate, promote, and discharge leased employees.[12] The subscriber's right to specify what services were needed, discharge

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T.C. 621, 629 (1975); Rev. Rul. 68-303, 1968-1 C.B. 165, 166, *republication revoked by* G.C.M. No. 39083, Dec. 1, 1983; Rev. Rul. 75-41, 1975-1 C.B. 323, 324.

The common law rules, as originally developed, relate primarily to whether a worker is an independent contractor or an employee. *See* Bartels v. Birmingham, 332 U.S. 126, 129 (1947); United States v. Silk, 331 U.S. 704, 716-19 (1947); Simpson v. Comm'r, 64 T.C. 974, 984-85 (1975); Ellison v. Comm'r, 55 T.C. 142, 153 (1970). Prior to Rev. Rul. 68-303 the common law rules had not been applied in the employee leasing context to determine which of two benefiting entities would be the employer.

9. Treas. Reg. § 31.3121(d)-(1)(c)(1), T.D. 6744, 1964-2 C.B. 344, 366-67, T.D. 7691, 1980-1 C.B. 228; *see* Treas. Reg. § 31.3401(c)-1(b), T.D. 6516 *unpublished, as amended by* T.D. 7068, 1970-2 C.B. 252.

These regulations summarize the key common law powers as developed by the courts in Bartels v. Birmingham, 332 U.S. 126 (1947); United States v. Silk, 331 U.S. 704 (1947); Simpson v. Comm'r, 64 T.C. 974 (1975); and Ellison v. Comm'r, 55 T.C. 142 (1970).

10. Rev. Rul. 68-303, 1968-1 C.B. 165, 166, *republication revoked by* G.C.M. No. 39083, Dec. 1, 1983.

11. Packard v. Comm'r, 63 T.C. 621, 630 (1975).

12. *See generally* Burnetta, O.D., P.A., v. Comm'r, 68 T.C. 367 (1977); Packard v. Comm'r, 63 T.C. 621 (1975); Rev. Rul. 68-303, 1968-1 C.B. 165, *republication revoked by* G.C.M. No. 39083, Dec. 1, 1983; Rev. Rul. 75-35, 1975-1 C.B. 131, *declared obsolete by* Rev. Rul. 81-105, 1981-1 C.B. 256; Rev. Rul. 75-41, 1975-1 C.B. 323.

employees when dissatisfied with their performance (as long as the subscriber had no right to affect the contract between the worker and the leasing organization), and demand an appropriate replacement were not necessarily determinative.[13]

Prior to section 414(n), attorneys could ensure that workers would be treated as employees of the leasing company and not the subscriber by carefully restricting and apportioning the rights enumerated above. In numerous private letter rulings[14] prior to the section's enactment taxpayers received favorable results after questioning whether their leasing arrangements violated the common law rules for determining the employer-employee relationship.[15]

Congress apparently did not rely on pre-section 414(n) authorities when it drafted the original statute. It replaced the common law guidelines with arbitrary tests[16] and safe harbor provisions that have no basis in prior cases or rulings.[17] Consequently, employers were able to use employee leasing schemes to circumvent the purpose of section 414(n).

III. Analysis

Careful analysis of section 414(n) demonstrates that the section, as enacted by Congress, is inconsistent with the intent or

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13. Rev. Rul. 75-41, 1975-1 C.B. 323.

14. Private letter rulings may not be cited as precedent. I.R.C. § 6110(j)(3) (Prentice-Hall 1985). However, in the absence of official releases, revenue rulings, or arguments stating the Service's position on employee leasing the private letter ruling remains the sole source for determining the Service's thoughts on the subject. *See* Holden & Novey, *Legitimate Uses of Letter Rulings Issued to Other Taxpayers—A Reply to Gerald Portney*, 37 Tax Law. 337 (1984). *But see* Portney, *Letter Rulings: An Endangered Species?*, 36 Tax Law. 751 (1983).

15. *See* Ltr. Rul. 8230155 (Apr. 30, 1982); Ltr. Rul. 8211045 (Dec. 16, 1981); Ltr. Rul. 8152100 (Sept. 30, 1981); Ltr. Rul. 8150068 (Sept. 17, 1981); Ltr. Rul. 8140083 (July 13, 1981); Ltr. Rul. 8136083 (June 15, 1981); Ltr. Rul. 8125021 (Mar. 24, 1981); Ltr. Rul. 7904087 (Oct. 26, 1978); Ltr. Rul. 7947002 (Aug. 9, 1978); Ltr. Rul. 7830140 (Apr. 29, 1978); Ltr. Rul. 7748037 (Aug. 31, 1977).

16. The common law guidelines were replaced by a mechanical test. I.R.C. § 414(n)(2) (Prentice-Hall 1985).

17. However, the safe harbor provisions look suspiciously close to the fact situation found in Ltr. Rul. 7947002 (Aug. 9, 1978) and other private letter rulings. *See, e.g.*, Ltr. Rul. 8125021 (Mar. 24, 1981).

In Ltr. Rul. 7947002 (Aug. 9, 1978) a leasing company maintained a money purchase pension plan on behalf of its employees. The plan provided full and immediate vesting, with almost immediate participation. Although obviously not conclusive, the provisions of 7947002 are similar enough to those contained in § 414(n)(5) that it is reasonable to believe that those responsible for the safe harbor provisions were aware of the letter ruling.

purpose for which it was drafted; that congressional attempts to rectify the problems associated with the section have been inadequate; and that, although the section remains effective, employee leasing exposes the subscriber to unacceptable risks.

A. *Intent of Section 414(n)*

Congress intended section 414(n) to prevent employers from using abusive employee leasing schemes to circumvent retirement plan rules. Evidence of this intent is found in several sources, including pre-section 414(n) history, legislative history to section 414(n), and changes made in other sections of the Internal Revenue Code at the same time section 414(n) was enacted.

1. *Pre-section 414(n) history*

Prior to section 414(n), employers occasionally used the employee leasing concept to avoid including non-key employees in their retirement plans. For example, in *Packard v. Commissioner*[18] three dentist-partners established a corporation to own the building and the equipment which they used in their dental practice. The partnership then made an agreement with the corporation to lease the equipment and space in the building.[19] The partnership had several employees: a general manager, bookkeeper, receptionist, janitor, and four dental assistants.[20]

Several years after establishing the corporation, the partnership transferred all of its employees to the corporation.[21] The corporation then contracted with the partnership to provide the partnership complete dental services.[22] The employees of the corporation continued to perform the same duties for the partnership that they had performed before being transferred to the corporation.[23]

Freed of rank and file employees, the partners established a profit-sharing plan exclusively for their own benefit.[24] Although the Tax Court essentially agreed[25] with the IRS that "the trans-

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18. 63 T.C. 621 (1975).
19. *Id.* at 623.
20. *Id.* at 624.
21. *Id.* at 623-24.
22. *Id.* at 624.
23. *Id.* at 625.
24. *Id.*
25. The Tax Court stated: "We recognize that there are objectives other than the

fer of the employees to the corporation was a subterfuge to permit the partners to adopt a profit-sharing plan benefiting themselves but not their employees,"[26] the court refused to find that the leased personnel were employees of the partners.

The court stated that Congress recognized that certain employers

> might separate the rest of the employees into separate entities to avoid having to cover them under plans established for their [the employer's] own benefit . . . . But in its wisdom Congress deliberately deleted a provision which would have required petitioners in this case to provide benefits for the employees of the corporation which they controlled.[27]

Although the Tax Court correctly determined Congress's intent when *Packard* was decided, Congress has since closed the *Packard* loophole.[28] At present, Congress will not allow employers to separate their employees into other entities in order to avoid covering them under plans established for the employer's benefit. Employee leasing schemes parallel *Packard* in that employers transfer their employees to separate leasing entities in order to avoid covering the workers under the firm's retirement plan. Thus the same policy that favored closing the loophole in *Packard* also favors closing the employee leasing loophole. It is therefore logical to assume that Congress desired to close the employee leasing loophole.

2. Legislative history of section 414(n)

Had there been lengthy debate over employee leasing on the Senate or House floors, or even in committee or conference meetings, one might easily determine Congress's reasons for enacting section 414(n). Unfortunately, no debate occurred. Furthermore, Congress's intent in passing section 414(n) cannot be found in any relevant *official* congressional document.[29] However, one *unofficial* source is particularly enlightening.

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tax considerations behind this retirement plan legislation; that generally it was designed to encourage employers to provide retirement benefits for employees, *which these petitioners appear to be trying to avoid doing.*" *Id.* at 633 (emphasis added).

26. *Id.* at 627.

27. *Id.* at 633.

28. I.R.C. § 414(b), (c) (Prentice-Hall 1985).

29. H.R. Rep. No. 760, 97th Cong., 2d Sess., *reprinted in* 1982 U.S. Code Cong. & Ad. News 1190; S. Rep. No. 494, 97th Cong., 2d Sess., *reprinted in* 1982 U.S. Code Cong. & Ad. News 781; S. Rep. No. 530, 97th Cong., 2d Sess. (1982); H.R. Rep. No. 404, 97th

The Compilation of Conferees' Decisions on the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) noted that "[r]elated rules would be provided to insure that an employer cannot avoid the top-heavy plans rules by establishing a plan under a one-man corporate shell or by *leasing employees from another employer*."[30] This is clear evidence that Congress intended to provide rules that would prevent an employer from circumventing the TEFRA amendments to retirement plan rules through employee leasing schemes.

3. I.R.C. sections 414(m) and 269A—changes made contemporaneously with section 414(n)

Congress has consistently attempted to achieve greater equity among retirement plan participants while closing loopholes in retirement plan rules.[31] The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)—the legislation of which section 414(n) is part—was no exception. In addition to enacting section 414(n), Congress closed other loopholes in retirement plan rules through sections 414(m)(5) and 269A.

Section 414(m)(5) covers an owner-employee who desires a retirement plan for his exclusive benefit. In the usual case covered by section 414(m)(5), the owner, *O*, separates himself from his corporation *A* by creating another corporation, *Z*. The sole purpose of corporation *Z* is to provide management services for corporation *A*. To meet its management obligations, *Z* hires *O* as its sole employee. As sole employee of the management corpora-

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Cong., 1st Sess. (1981); JOINT COMM. ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 (Joint Comm. Print 1982).

30. HOUSE COMM. ON WAYS AND MEANS, 97TH CONG., 2D SESS., COMPILATION OF CONFEREE'S DECISIONS ON H.R. 4961, THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 26 (Comm. Print 1982).

31. *See, e.g.*, Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426 (codified as amended in scattered sections of 26 and 29 U.S.C.); Deficit Reduction Act of 1984 (Division A—Tax Reform Act of 1984), Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of 26 U.S.C.); Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 and 42 U.S.C.); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.); Multiemployer Pension Plan Amendments Act of 1980, Pub. L. No. 96-364, 94 Stat. 1208 (codified as amended in scattered sections of 26 and 29 U.S.C.); Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (codified as amended in scattered sections of 26 U.S.C.); Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended in scattered sections of 26 U.S.C.); Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 26 and 29 U.S.C.).

tion, *O* can establish a retirement plan for his exclusive benefit. Absent section 414(m)(5), this strategy would be legal.

Section 269A covers a similar situation. Professional *P* desires a retirement plan for his exclusive benefit. *P*, who is a partner in a professional partnership establishes corporation *X*. *X*'s sole purpose is to provide personal services to the partnership. To fulfill its obligation, *X* hires *P*. As sole employee of *X*, *P* is free to set up his exclusive retirement plan. Absent section 269A this tactic would also be legal.[32] The conference report states that the provisions in section 269A were intended to "overturn the results reached in cases . . . where the corporation serve[s] no meaningful business purpose other than to secure tax benefits which would not otherwise be available."[33]

Sections 269A and 414(m)(5) shed light on the intent behind section 414(n). Although the strategies prohibited by sections 269A and 414(m)(5) differ from the employee leasing scheme covered by section 414(n), the discriminatory result achieved by each strategy is identical. Since the result obtained through employee leasing is no different from that obtained in the schemes prohibited by sections 269A and 414(m)(5), Congress must have intended section 414(n) to prohibit the circumvention of retirement plan rules through employee leasing.

B. Congressional Amendments to Section 414(n)

As originally drafted, section 414(n) stated in pertinent part:

> (1) In General.—For purposes of [certain] pension requirements[34]. . .
>
> (A) the leased employee shall be treated as an employee of the recipient, but
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> (B) contributions or benefits provided by the leasing or-

32. Keller v. Comm'r, 77 T.C. 1014 (1981).

33. H.R. Rep. No. 760, 97th Cong., 2d Sess. 634, *reprinted in* 1982 U.S. Code Cong. & Ad. News 1190, 1406.

34. *See* I.R.C. § 414(n)(3) (Prentice-Hall 1985). A leased employee will be treated as an employee of the subscriber for purposes of § 401(a)(3) (requiring that minimum participation standards of § 410 be met); § 401(a)(4) (prohibiting discrimination in favor of officers, shareholders, or highly compensated employees); § 401(a)(7) (requiring that minimum vesting standards of § 411 be met); § 401(a)(16) (requiring that benefits or contributions not exceed the limitations of § 415); § 408(k) (relating to simplified employee pensions); § 410 (minimum participation standards); § 411 (minimum vesting standards); § 415 (limitations on benefits and contributions under qualified plans); and § 416 (special rules for top-heavy plans).

ganization which are attributable to services performed for the recipient shall be treated as provided by the recipient.

(2) Leased Employee.—For purposes of paragraph (1), the term "leased employee" means any person who provides services to the recipient if—

(A) such services are provided pursuant to an agreement[35] between the recipient and any other person . . .

(B) such person has performed such services for the recipient . . . on a substantially full-time basis for a period of at least 1 year[36], and

(C) such services are of a type historically performed, in the business field of the recipient, by employees.

(5) Safe Harbor.—This subsection shall not apply to any leased employee if such employee is covered by a plan which is maintained by the leasing organization if, with respect to such employee, such plan—

(A) is a money purchase pension plan[37] with a nonintegrated[38] employer contribution rate of at least 7 ½% percent, and

(B) provides for immediate participation and for full and immediate vesting.[39]

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35. The agreement may be oral or written. Treas. Notice 84-11, 1984-29 I.R.B. 31 (Q & A-6).

36. A person will be considered to have met this requirement if during any consecutive 12-month period (1) the worker has performed at least 1500 hours of service for the recipient, or (2) the worker has performed services for the recipient equal to at least 75% of the average number of hours that are typically performed by an employee of the recipient. *Id.* (Q & A-7).

37. Under a money purchase pension plan, a percentage of an employee's pay (normally 5 to 10%) is set aside in a pension fund by the employer. In many instances, the employee may match the employer's contribution. The amount of retirement benefit will be the amount the total contribution to the pension plan can purchase upon retirement.

38. Integration requires that benefits received under a private retirement plan be coordinated with social security benefits. Employees earning more than the social security wage base must not receive combined benefits under several retirement programs proportionately greater than benefits for employees who earn less than the taxable wage base. Therefore, the combined social security and private retirement plan benefits must produce a total retirement benefit that is relatively equal to the percentage of compensation for all employees, whether highly compensated or not.

39. Although an employer is usually required to make contributions to the retirement plan on behalf of plan participants, generally the money contributed does not immediately belong to the covered workers. A participant is vested only in a certain percentage of the funds contributed. The percentage usually increases each year based upon some predetermined schedule. Employee leasing requires that the leased employee be immediately entitled to the full amount contributed.

In simple terms section 414(n) states that a subscriber must treat a leased employee as his own employee for purposes of retirement plan requirements unless the leased employee is covered under the safe harbor provisions. The statute, as originally drafted, had two key problems. First, it did not define leased employees in terms of the common law test. Second, the safe harbor rules were overly broad. Congress attempted to remedy these problems by amending section 414(n).

1. The common law employee problem

The first problem with section 414(n) was that the definition of leased employee did not incorporate the common law test utilized by the IRS and Tax Court in pre-section 414(n) cases and rulings. This oversight allowed employees to be considered "leased employees" for purposes of the safe harbor provisions even though their former employers maintained control over them. For example, subscribers who entered into immediate leaseback arrangements with leasing organizations were not required to give up control over their former employees as long as the leased employees were covered by the safe harbor provisions. Thus, a subscriber could establish an exclusive retirement plan for his benefit without any substantive change in the employer-employee relationship.

In July of 1984 Congress amended the definition of "leased employee" to prevent employers from utilizing the preceding strategy. Congress eliminated the words "any person" in the definition of leased employee and inserted the words "any person who is not an employee of the recipient."[40] This change was intended to exclude any leased employees who were simultaneously common law employees of the recipient. As the House report accompanying the Tax Reform Act of 1984 states: "The committee is aware that some individuals have interpreted the present law safe harbor rules as overriding traditional common-law employee rules. The committee believes that present law should be clarified to prevent this interpretation."[41] Thus, leased

40. Deficit Reduction Act of 1984 (Division A—Tax Reform Act of 1984), Pub. L. No. 98-369, § 526(b)(1), 98 Stat. 494, 874.

41. H.R. REP. No. 432, 98th Cong., 2d Sess. 1634, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 697, 1258. Congress was not the only government entity to recognize that the original draft of § 414(n) had omitted the common law guidelines from the definition of leased employee. The Treasury, in guidelines issued over employee leasing, also indicated that the definition of leased employee excluded common law employees. Treas.

workers are not covered by the safe harbor provisions if they qualify as common law employees of the subscriber.[42]

2. *The safe harbor problem*

The second major problem with section 414(n), not corrected by congressional amendments in 1984, is the broad language of the safe harbor provisions. Congress intended by enacting 414(n) to prevent discrimination among retirement plan participants. To achieve its purpose Congress enacted an all-encompassing employee leasing statute. Unfortunately, the safe harbor provisions in the statute are equally expansive. The net result of 414(n) is to authorize the very strategy Congress sought to prohibit. The general rule of section 414(n), that leased employees be treated as belonging to the subscriber, has been swallowed by the statute's safe harbor provisions.

One possible explanation for this result is that the safe harbor provisions were the result of "lobbyists working in Washington on behalf of employee-leasing companies."[43] However, the existence of the safe harbor provisions is probably not solely attributable to the efforts of lobbyists.

Another possible explanation is that not all leasing companies involve schemes designed to circumvent the retirement plan requirements. Many employee leasing firms serve valid business purposes. Recognizing this fact, Congress may have desired a set of rules that would allow legitimate employee leasing companies to operate while shutting down the real scams.[44] This rationale, however, has a major flaw. Congress could have recognized legitimate uses of employee leasing without enacting the safe harbor provisions. Legitimate leasing companies typically lease personnel to subscribers on a temporary basis. Such companies do not come within section 414(n)'s grasp as long as their leased em-

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Notice 84-11, 1984-29 I.R.B. 31 (Q & A-3).

42. *See supra* notes 6-17 and accompanying text.

43. Sahagun, *Employee Leasing: As Companies Proliferate, Controversy Mounts*, L.A. Times, May 6, 1984, at 2, col. 1.

44. Language contained in the Conference Report accompanying the 1984 amendments to § 414(n) illustrates that Congress ultimately recognized that not all employee leasing schemes constitute an abuse of the retirement plan rules. Specifically, the Report states, ". . . the conferees do not intend to imply that legitimate uses of employee leasing are necessarily abuses." H.R. REP. No. 861, 98th Cong., 2d Sess. 1143, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 751, 1137.

ployees do not work for a particular employer for more than one year.[45]

Another explanation for the safe harbor provisions might be that Congress decided that requiring leasing organizations to provide a seven-and-one-half percent money purchase pension plan[46] for leased employees was an equitable tradeoff for allowing employers to maintain an exclusive plan. This rationale also has a major weakness. If Congress truly felt that a money purchase pension plan was an equitable tradeoff, why did it not simplify the entire field of retirement plan rules by allowing every employer to establish his own plan as long as he maintains the type of plan described in the safe harbor provisions for his employees?

Whatever the reasons for enacting the safe harbor provisions, they are overly broad and undermine the purpose of section 414(n). As long as they remain in their current form, employee leasing schemes will proliferate.

In addition to being overly broad, the safe harbor provisions fail to recognize two specific factors used by the IRS in determining whether a given employee leasing plan is legitimate. First, the IRS has been concerned with the permanency of the relationship between the subscriber and the leased employee.[47] The more permanent the relationship, the more employee leasing appears to be a strategy for avoiding participation and coverage requirements. Second, the IRS has been concerned with the leaseback of workers to their former employers.[48] The immediate leaseback of employees, especially when unaccompanied by a

45. I.R.C. § 414(n)(2)(B) (Prentice-Hall 1985); *see supra* note 36 and accompanying text.

46. I.R.C. § 414(n)(5)(A) (Prentice-Hall 1985).

47. Evidence of this concern can be found in numerous private letter rulings. *See* Ltr. Rul. 8230155 (Apr. 30, 1982); Ltr. Rul. 8211045 (Dec. 16, 1981); Ltr. Rul. 8140083 (July 13, 1981); Ltr. Rul. 8125021 (Mar. 24, 1981); Ltr. Rul. 7947002 (Aug. 9, 1978); Ltr. Rul. 7830140 (Apr. 29, 1978); Ltr. Rul. 7748037 (Aug. 1, 1977).

In Ltr. Rul. 7748037 (Aug. 1, 1977), the IRS commented that "the question of who is the employer in a situation in which a worker is placed with one subscriber for an extended period of time must be resolved on the facts of that particular work relationship." A number of private letter rulings have implied that the extended period of time referred to in Ltr. Rul. 7748037 is one year. *See, e.g.*, Ltr. Rul. 8230155 (Apr. 30, 1982); Ltr. Rul. 8211045 (Dec. 16, 1981); and Ltr. Rul. 8140083 (July 13, 1981).

48. *See* Ltr. Rul. 8125021 (Mar. 24, 1981); Ltr. Rul. 7947002 (Aug. 9, 1978); and Ltr. Rul. 7830140 (Apr. 29, 1978). The IRS noted in Ltr. Rul. 7830140 (Apr. 29, 1978), that unless a definite termination of the employment relationship occurred between a subscriber and its former workers, any former workers leased back to the subscriber would be treated as the subscriber's employees.

substantive change in the employer-employee relationship, intuitively suggests that the transaction is a deliberate attempt to bypass ERISA requirements. As stated previously, the safe harbor provisions contained in section 414(n)(5) provide that leased workers will not be treated as employees of the subscriber for purposes of pension requirements if the leased employees are covered by a seven-and-one-half percent money purchase pension plan that provides for immediate participation and for full and immediate vesting. A leased employee can meet the preceding test whether he is a permanent leased employee of the subscriber or whether he has been terminated and leased back to his former employer.

Congress's failure to account for these loopholes allows subscribers to discriminate at will with respect to leased employees. For example, a subscriber who uses permanent leased employees—assuming they qualify for safe harbor coverage—can establish an exclusive retirement plan for his benefit without including his permanent leased workers. Employers who choose to do business with regular permanent employees have no such opportunity. This disparity is inequitable.

The same is true for subscribers who immediately leaseback their former employees. A subscriber can maintain his former employees with essentially no substantive change in the employment relationship and yet establish an exclusive plan for the employer's benefit—assuming that the leased workers fall within the safe harbor coverage and are not common law employees. Employers who choose not to make the paper transfer have no such opportunity.

Although Congress failed to amend section 414(n) in 1984 to account for these problems, it recognized that additional changes in the statute would be necessary. To provide for additional changes Congress enacted section 414(o) to prevent further abuses in the area of employee leasing. The section states in pertinent part:

> (o) Regulations.—The Secretary shall prescribe such regulations . . . as may be necessary to prevent the avoidance of any employee benefit requirement. . . through the use of—
> (1) separate organization
> (2) employee leasing, or
> (3) other arrangements.[49]

49. I.R.C. § 414(o) (Prentice-Hall 1985).

This new subsection was meant to prevent employers from circumventing retirement plan rules through employee leasing schemes. The statutory authority granted by section 414(o) could be used to bring about necessary changes to the safe harbor provisions.

3. *Proposed solution*

Revising section 414(n) would help prevent circumvention of retirement plan rules through employee leasing schemes. The exclusion of common law employees from the definition of leased employee is only one step. Additional changes are necessary to seal up existing loopholes. For example, if the safe harbor provisions are not repealed altogether, either Congress through amending the law, or the secretary of the treasury through promulgating regulations, must appropriately deal with permanency and leaseback issues. The only way to prevent further employee leasing schemes is to prevent subscribers from using these tactics.

The leaseback issue might be handled by restricting the scope of the safe harbor provisions as follows:

> (7) Exception to Safe Harbor.—
>
> (A) Paragraph (5) shall not be effective with respect to any employee described in paragraph (2) if such employee has *at any time* been considered, under the usual common law rules applicable in determining the employer-employee relationship, an employee of the recipient.

This language makes clear that subscribers will not be able to engage in an immediate leaseback strategy. On the other hand, the language will not adversely affect leasing organizations that assign an individual worker numerous times to the same subscriber—assuming that the leased worker has never been a common law employee of the subscriber.

The permanency issue is more difficult to remedy. As indicated previously, employers who utilize permanent leased employees should not be allowed to establish discriminatory retirement plans when employers who use regular permanent employees cannot. The following proposal would eliminate the permanency loop hole:

> (7) Exceptions to Safe Harbor.—
>
> (A) Immediate Leaseback. [language from above]

(B) Permanent Employees. Paragraph (5) shall not be effective with respect to any employee described in paragraph (2) if such employee has performed services for the recipient on a substantially full-time basis for a period of at least 1 year.

This language would ultimately have the same effect as repealing the safe harbor provisions: all leased employees who have performed services for the subscriber on substantially a full-time basis for at least one year would be treated as employees of the subscriber. However, the proposed statute would cleanly and efficiently prohibit discrimination among retirement plan participants and achieve parity between employers who use permanent leased employees and those who use regular employees.[50]

The preceding proposals recognize and deal with the leaseback and permanency issues. They should be viewed as a starting point for discussion of how to prevent employee leasing schemes from undermining retirement plan requirements.

C. *Tax Risks Involved With Employee Leasing*

While the preceding analysis may be important to Congress, the IRS, and the secretary of the treasury, small businessmen and professionals operate on a much more practical level. Despite congressional intent, section 414(n) remains in effect. Thus, the strategy may appear desirable to individuals who want to establish exclusive retirement plans. The final section of this comment argues that the tax risks of an employee leasing program[51] outweigh its benefits. The following discussion treats only those tax risks with the most severe consequences.

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50. Congress authorized the secretary of the treasury to provide regulations that would prevent employee leasing abuses in all situations except when leased workers were being used for temporary needs. This action arguably implies that Congress was aware of the permanency issue. Congress did not authorize the secretary to issue rules when "the project has an ascertainable termination date and it is not customary under the circumstances to hire permanent employees for such a project." H.R. REP. No. 861, 98th Cong., 2d Sess. 1143-44, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 751, 1138-39.

51. This comment discusses only leasing arrangements with one purpose: the circumvention of retirement plan rules. This comment does not propose to discuss the merits of legitimate programs, such as "Kelly Girl."

1. Retirement plan termination

The IRS will not tolerate immediate leaseback of employees unless definite termination of any former employer-employee relationship occurs.[52] However, by complying with this requirement a subscriber creates another problem: his existing retirement plan may be deemed partially or completely terminated. For example, suppose an owner-employer in a closely-held corporation transfers his employees to a leasing company. The owner-employer consciously decides to discontinue a defined benefit plan and establish a profit-sharing plan for his exclusive benefit. Under this scenario, a complete termination has occurred.

Whether a plan is terminated is generally a factual question.[53] A few complete terminations occur accidentally, but most involve a conscious decision to discontinue a plan.[54] The consequences of a complete termination are the same whether the plan was terminated by conscious decision or by accident. A number of these consequences are shared with partial terminations and will be discussed below. However, some consequences are unique to complete terminations.[55] For example, if a plan is completely terminated the employer may be liable for guaranteed benefits to the Pension Benefit Guaranty Corporation (PBGC).

Congress established the PBGC under Title IV of ERISA[56] to administer the termination insurance program. This program ensures that employers will not underfund a retirement plan and then terminate the plan at will, leaving participants without benefits.[57] Accordingly, section 4062(b) of ERISA[58] provides that an employer who has voluntarily terminated a plan with insufficient assets to pay guaranteed benefits will be liable to PBGC in

52. *See supra* note 48.

53. Treas. Reg. § 1.401-6(b)(1) (1963).

54. Carlin & Saake, *Pension Plan Terminations: Practical Problems After ERISA*, 1 CORP. L. REV. 123, 128 (1978).

55. Under Title IV of ERISA as originally enacted, only complete termination gave rise to employer liability. However, as amended by the Multiemployer Pension Plan Amendments Act of 1980, Pub. L. No. 96-364, 94 Stat. 1208 (codified as amended in scattered sections of 26 and 29 U.S.C.), Title IV of ERISA now allows employer liability for both partial and complete terminations, but only in the case of multiemployer plans. For single employer plans, complete termination is still required.

56. 29 U.S.C. § 1302 (1982).

57. *See Plan Terminations and Mergers*, 357 TAX MGMT. (BNA) A-1 (1983).

58. 29 U.S.C. § 1362(b)(2) (1982).

the amount of the insufficiency, up to thirty percent of the employer's net worth. Since not all retirement plans come under the purview of Title IV of ERISA,[59] some subscribers may be insulated from its provisions. However, subscribers who are not insulated should be advised of the risk of liability.

A partial termination occurs when a *group* of employees who have been covered by a retirement plan are discharged by their employer.[60] Exactly how large this group of excluded employees must be is unclear. In Revenue Ruling 81-27 the IRS ruled that the discharge of 95 of 165 employees due to the closing of a business division was a partial termination.[61] The IRS stated that the "holding would apply irrespective of whether the significant decrease in participation in the plan was the result of adverse economic conditions or causes within the control of the employer."[62] Similarly, in Revenue Ruling 73-284 the IRS ruled that a partial termination had occurred when twelve of fifteen employees were discharged after they failed to transfer with the business to a new location.[63]

Each of the preceding Revenue Rulings involved discharges of significantly more than fifty percent of the employees. However, evidence suggests that discharging as few as twenty percent of a business's employees may result in a partial termination. This conclusion is based on the fact that a decrease in plan participants by twenty percent or more is a reportable event to the PBGC under section 4043(b)(3) of ERISA.[64] Under either the fifty or twenty percent threshold, most employee leasing arrangements clearly result in a partial termination of existing retirement plans. Once a partial or complete termination has occurred, potentially severe consequences may follow, such as plan disqualification or full and immediate vesting of employee benefits.

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59. Title IV of ERISA does not cover complete terminations involving the following plans: (1) profit-sharing plans and other defined contribution plans; (2) public employee, church, and government plans; (3) unfunded deferred compensation plans; and (4) professional service employer plans with not more than 25 active employees at any time after September 2, 1974. 29 U.S.C. § 1321 (1982).

60. Treas. Reg. § 1.401-6(b)(2) (1963).

61. Rev. Rul. 81-27, 1981-1 C.B. 228.

62. *Id.*

63. Rev. Rul. 73-284, 1973-2 C.B. 139-40.

64. 29 U.S.C. § 1343(b)(3) (1982); *see also Plan Terminations and Mergers*, 357 TAX MGMT. (BNA) A-14 (1983).

a. Plan disqualification. The most severe consequence of a plan termination is disqualification of the retirement plan. If the plan is disqualified, employer contributions are not deductible, employees are currently taxed on employer contributions to the plan, and income earned by the retirement trust is taxable.[65] In addition, the IRS may determine that the disqualification should be applied retroactively, beginning with the date the plan was established.

Disqualification of the retirement plan is justified because the plan does not meet Treasury requirements that retirement plans be permanent.[66] If a plan is abandoned within a few years of its establishment, the IRS presumes that the plan was not initially a bona fide plan. [67] Rebutting this presumption requires a showing that the plan was abandoned out of business necessity.[68] Business necessity has been defined as "adverse business conditions, not within the control of the employer, under which it is not possible to continue the plan."[69] This standard is usually satisfied only by such drastic causes as bankruptcy or insolvency—events considered as prima facie evidence of business necessity.[70] Voluntarily abandoning a plan for employee leasing purposes—a condition within the control of the employer—clearly fails the business necessity requirement.

The IRS has also rejected the argument that plan termination is justified by lack of a force of employees in the company who could benefit under the plan.[71] Therefore, employers who

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65. *See supra* note 2.

66. Treas. Reg. § 1.401-1(b)(2), T.D. 6675, 1963-2 C.B. 151, T.D. 6722, 1964-1 C.B. 144, T.D. 7168, 1972-1 C.B. 118. The Treasury Service is concerned that pension plans may be abandoned "soon after pensions have been funded for persons in favor of whom discrimination is prohibited under section 401(a)." *Id.*

67. The number of years a plan must exist to escape the "few years" language upon termination is unclear. Several cases and revenue rulings have discussed in general terms the need for permanency in retirement plans, but none have been directly on point. *See* Sutherland v. Comm'r, 78 T.C. 395 (1982); Estate of Benjamin v. Comm'r, 54 T.C. 953 (1970); Rev. Rul. 83-83, 1983-1 C.B. 86; Rev. Rul. 77-139, 1977-1 C.B. 278. Although these authorities are unclear, the treasury regulations imply that if a retirement plan is terminated after pensions have been funded for key employees and not for the rank and file—regardless of how many years the plan has been in existence—the IRS will presume that the plan was not a bona fide program from its inception. *See* Treas. Reg. § 1.401-1(b)(2), T.D. 6675, 1963-2 C.B. 151, T.D. 6722, 1964-1 C.B. 144, T.D. 7168, 1972-1 C.B. 118.

68. Rev. Rul. 69-25, 1969-1 C.B. 113.

69. *Id.*

70. *Id; see also Plan Terminations and Mergers*, 357 TAX MNGT. (BNA) A-11 (1983).

71. Rev. Rul. 69-24, 1969-1 C.B. 110, 112.

discharge their employees within a few years of establishing a retirement plan will probably be deemed to have partially terminated that plan. Since employee leasing cannot qualify as a valid business purpose, the employer's retirement plan will then probably be disqualified for the current year and retroactively.

b. Full and immediate vesting. In addition to the risk of plan disqualification, termination of a qualified plan presents problems with vesting.[72] I.R.C. section 411(d)(3) requires, whether the termination is complete or partial, that affected employees be completely and immediately vested.[73] Two important qualifications to this rule exist.

The first qualification is the "early termination" rule. Under I.R.C. section 411(d)(3) and Treasury Regulation 1.404-4(c) the amount of funds that highly compensated employees are allowed to retain is limited if a plan is terminated within ten years of being established. The purpose of the rule is to "preclude an employer from funding the benefits payable to the most highly compensated employees and then terminating the plan . . . leaving the rank and file employees with accrued but unfunded benefits."[74]

The second qualification involves asset allocation. The rules governing asset allocation are complex and beyond the scope of this comment.[75] However, they generally allow retirement fund assets to be reallocated upon termination of the plan. Reallocation precludes discrimination among employees and is accomplished by setting up and following certain priorities.

Early termination and asset reallocation will directly affect the subscriber since he is generally treated as a highly compensated employee, officer, or shareholder. Therefore, the subscriber faces a substantial risk that when his retirement plan terminates he may have to forfeit a portion of the funds set aside for his economic security.

Finally, the vesting requirement imposed under a partial termination benefits employees with shorter service at the expense of employees with longer service. For example, when a short-term employee leaves a company's employment he forfeits all unvested funds to the retirement plan. These funds are real-

72. Vesting refers to obtaining an unforfeitable right to retirement funds that have been contributed on the employee's behalf.

73. I.R.C. § 411(d)(3) (Prentice-Hall 1985).

74. *Plan Terminations and Mergers*, 357 TAX MGMT. (BNA) A-12 (1983).

75. 29 U.S.C. § 1344 (1982); Treas. Reg. § 1.411(d)-2(a)(2) (1977).

located to the continuing long-term participants. However, if the short-term employee leaves a company's employment during a partial termination the rules change. The short-term employee receives one hundred percent of his funds; the funds are not reallocated to the remaining employees. Thus, the short-term employee receives funds that would otherwise have gone to the long-term employees.[76] This is another disadvantage that the subscriber, who for all practical purposes will be a long-term employee under the company's retirement plan, must accept if he wishes to utilize employee leasing.

2. *Withholding of income and employment taxes*

Section 414(n) is concerned only with treating leased workers as employees of the subscriber for specific retirement plan provisions. Whether a worker is also the subscriber's employee for withholding and employment tax purposes is a common law determination.[77] Thus, subscribers may unexpectedly find themselves as the employer for withholding of income and employment taxes, in addition to retirement purposes, if the leasing company improperly structures the leasing contract. For example, illegitimate leasing companies may structure contracts to leave key rights with the subscriber or the subscriber may inadvertently exercise key rights. Either way, the subscriber is subject to an economic liability risk.

Furthermore, a subscriber who carefully avoids retaining too much control over leased workers may still be treated as the employer if the worker is placed with the subscriber for an extended period of time. Safe harbor provisions have no effect on withholding; thus, the issue of permanency resurfaces.[78]

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76. Carlin & Saake, *supra* note 54, at 130.

77. Although the final determination of this issue will be made by a court of law, in Ltr. Rul. 8328104 (Apr. 15, 1983), the IRS indicated that the common law rules would govern the employer-employee relationship for purposes of withholding and employment taxes. This result is in line with the language of § 414(n) that leased employees will be treated as employees of the subscriber only for purposes of certain retirement plan requirements.

It should also be noted at this point that in Ltr. Rul. 8328104 (Apr. 15, 1983) the leasing corporation requested a determination that leased workers were not employees of the subscriber for purposes of § 414(n). This is the first private letter ruling to make such a request under the new law. The IRS has not yet responded.

78. *See supra* note 47 and accompanying text.

3. *Risks from unanswered questions*

Like all new legislation, section 414(n) raises a host of issues that will remain unresolved until the courts rule on them. For example:

1. May leasing companies avoid the "one year" requirement of section 414(n) altogether by structuring subscription contracts to terminate every six months?[79]

2. Do the safe harbor provisions exempt a subscriber from treating leased workers as his employees for purposes of a medical reimbursement plan, in addition to retirement plan purposes?

3. How will section 414(n) affect common law tort and loaned servant doctrines?

4. In the event a leasing organization is adjudicated bankrupt, who will be ultimately responsible for state and federal taxes and delinquent retirement plan contributions? Will subscribers who have placed money on deposit with leasing companies be able to recover their funds?[80]

5. Will subscribers in states that do not recognize employment at will contracts be liable for discharging employees who are unwilling to transfer to a leasing company?

The resolution of each of the preceding issues could have disastrous effects for the subscriber. These risks alone, without considering the risks of plan termination or disqualification, outweigh the benefits of employee leasing.

IV. Conclusion

In I.R.C. section 414(n) Congress has enacted a statute inconsistent with Congress's intent to prohibit discrimination among retirement plan participants. Instead of preventing circumvention of retirement plan rules, section 414(n) encourages it. Congressional amendments in 1984 failed to correct the loopholes inherent in the language of section 414(n). Thus, discrimination will continue among retirement plan participants who utilize employee leasing schemes unless the present statute is amended.

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79. Arguably, by structuring contracts to end after a period of six months, no worker has performed services for a particular subscriber for more than six months. Thus, the worker would, presumably, fail to meet the leased employee definition of § 414(n) and not come within the section's grasp.

80. *See* Sahagun, *supra* note 43.

In the meantime, although employee leasing continues to be a valid scheme authorized by safe harbor provisions, the strategy subjects the subscriber to unacceptable tax risks: liability for obligations arising out of complete or partial plan termination and disqualification, treatment as the employer of leased personnel for purposes of withholding and employment taxes, treatment as the employer for purposes of qualifying a medical reimbursement plan, liability for obligations in the leasing company's bankruptcy, liability for unlawful discharge of employees, and liability for leased employee's torts. These risks outweigh the benefits of employee leasing.

David A. Channer