Independent Contractors and Qualifying Corporate Pension Plans under the Employee Retirement Income Security Act after Vizcaino v. Microsoft

Mary Clare Gartland
Small businesses and large corporations are increasingly using temporary workers, such as independent contractors, to supplement their workforce. Many statutes regulating employment relationships, however, cover "employees" but not independent contractors. The resulting struggle over a label—employee versus independent contractor—lies at the center of misclassification disputes.

Misclassification occurs when businesses classify workers as independent contractors, but the Internal Revenue Service (IRS) considers them employees. The IRS determines whether a worker is an employee or an independent contractor by using a twenty-factor common-law test.
commonly referred to as the right-to-control test.5 "No single factor is
determinative, and the language of an agreement will not prevail over
the reality of the relationship."6

Employers need to be wary of worker misclassification, especially be-
cause the IRS has recently intensified its scrutiny of employment rec-
ords.7 Classifying workers incorrectly as independent contractors may
create enormous tax liabilities, including payroll taxes, interest, and pen-

5. See Thomas M. Murray, Independent Contractor or Employee? Misplaced Reli-
ance on Actual Control Has Disenfranchised Artistic Workers Under the National Labor
Relations Act, 16 CARDOZO ARTS & ENT. L.J. 303, 309 (1998) (providing that the right-to-
control test applies when a company not only directs what work shall be done, but also
how the work is to be done). When a company reserves the right to control the work of a
hired party, the company will be responsible for the acts of the hired party. See id.

6. DANIEL S. KLEINBERGER, AGENCY AND PARTNERSHIP: EXAMPLES AND

7. See Claudia L. Kelley, Worker Misclassification Affects More than FICA,
60 TAX'N FOR ACCT. 96, 96 (Feb. 1998) (explaining that the IRS "has reclassified more
than 400,000 independent contractors as employees" over the past several years as a result
of a nationwide employment tax examination program).
When employers incorrectly classify common-law employees as independent contractors, they do not merely owe back taxes on the employees, but also risk disqualification for preferential tax treatment with respect to pension plans. This risk of disqualification is substantial because the IRS allows corporations tax deductions for providing pension benefits to their employees. In order to receive these tax benefits, a corporation’s pension plan must meet the requirements of the Employee Retirement Income Security Act (ERISA). ERISA ensures that employers do not extend their benefit packages solely to high-salaried employees, but also to a large number of lower-paid employees. Independent contractors, however, are not included within ERISA’s protections. Employers, therefore, traditionally have not provided benefits to independent contractors.

The Ninth Circuit’s recent decisions in Vizcaino v. Microsoft highlight the potential consequences arising from worker misclassification. The Vizcaino decisions focus on Microsoft’s contractual agreements with a large number of independent contractors. The independent contractors agreed to forego benefits to obtain higher salaries, in contrast to employ-

8. See id. at 97; Barron, supra note 4, at 461 (explaining employers’ tax obligations to employees). The tax obligations include the employer contributing an employee’s share of Social Security and those payments due under FICA, FUTA, and federal government income taxes. See id.

9. See Kelley, supra note 7, at 101 (explaining that “[t]he misclassification of workers may result in one or more violations of the qualified plan rules”). However, there are indications that the IRS will not necessarily disqualify a plan because of misclassification as long as the employer makes timely corrections and provides the retroactive benefits to the misclassified workers. See id.

10. See MICHAEL D. ROSE & JOHN C. CHOMMIE, FEDERAL INCOME TAXATION § 5.02, at 254 (3d ed. 1988) (providing that the employer receives a tax deduction for a contribution to a qualified plan on behalf of an employee). Moreover, an employer’s contributions to a qualified plan for an employee are not taxable, nor is the income from the amount contributed. See id. In addition, employees are not taxed on the payments from a qualified plan until they receive payment. See id.


12. See Higgins, supra note 3, at 26 (“ERISA established pension-fund standards for participation, vesting, minimum funding and termination insurance coverage.”).

13. See ROSE & CHOMMIE, supra note 10, at 274 (providing that the initial determination is whether the worker is an employee).

14. See id. (explaining that a qualified benefit plan is exclusively for the benefit of employees, and that employee status is based on the right-to-control test).

15. 97 F.3d 1187 (9th Cir. 1996) (Vizcaino I), vacated, 105 F.3d 1334 (9th Cir. 1997), aff’d on r’hg en banc, 120 F.3d 1006 (9th Cir. 1997) (Vizcaino II).

16. See id. at 1189.
ees performing similar jobs who received benefits but lower salaries. Applying the right-to-control test, the IRS determined that Microsoft's workers were employees rather than independent contractors. Consequently, the workers sued for employee benefits.

This Note examines the relationship between the determination of independent contractor status and qualified corporate pension plans in light of Vizcaino v. Microsoft. First, this Note briefly examines the influence of common-law agency principles on statutes regulating "employee" benefits, focusing on the right-to-control test, which courts use to determine whether a worker is an employee or an independent contractor. Next, this Note traces the procedural history of Vizcaino and analyzes the issues it presents. This Note then outlines the ERISA regulations governing qualified pension plans and provides alternative remedies for avoiding conflicts with the IRS over worker classification. Finally, this Note concludes by suggesting preventive measures available to employers seeking to minimize the risks of liability for worker misclassification.

I. EMPLOYEE OR INDEPENDENT CONTRACTOR?: USING THE RIGHT-TO-CONTROL TEST TO DETERMINE EMPLOYMENT STATUS

Common-law agency principles influenced many statutes intended to regulate or tax modern employment relationships. Typically, these statutes cover employees but not independent contractors, or the statutes provide an ambiguous definition of employee that gives rise to misclassification disputes. Consequently, many courts turn to agency principles to resolve these controversies.

The common-law test for determining whether a worker is an employee or an independent contractor, known as the right-to-control test, originated in the mid-nineteenth century in English and American courts to resolve questions of liability in tort cases. Initially, the definition of

17. See Alvin D. Lurie, Not a Soft Landing for Microsoft, 73 TAX NOTES 1359, 1359 (1996) (analyzing the Vizcaino II decision and opining on its likely affect on the "tens of thousands of businesses, large and small" that have sought to supplement their work force with independent contractors).
18. See Vizcaino II, 120 F.3d at 1008.
19. See id. at 1009.
20. See KLEINBERGER, supra note 6, at 87-88.
21. See discussion infra Parts I.A-D.
22. See Gerald M. Stevens, The Test of the Employment Relation, 38 MICH. L. REV. 188, 189 (1939). The distinction between an employee-employer relationship and an independent contractor-employer relationship is important for three main reasons: first, to resolve a claim for an employer's liability for the tort of an alleged employee or the duty to provide workers' compensation; second, for preference under the insolvency statutes or
an employee became important in determining vicarious liability under the doctrine of respondeat superior.\textsuperscript{23} Early courts applying the right-to-control test sometimes framed it in terms of "whether the defendant retained the power of [controlling] the work."\textsuperscript{24} In the early twentieth century, courts used the analytical framework that originated in the respondeat superior cases to determine whether workers were independent contractors or employees in the context of awarding certain employment benefits.

\textbf{A. Early Use of Classification to Award Employee Benefits}

In 1921, an Illinois court employed the right-to-control test in deciding whether a mineworker was an employee or an independent contractor in \textit{Franklin Coal & Coke Co. v. Industrial Commission.}\textsuperscript{25} An injured worker became entitled to workers' compensation once the Industrial Commission determined he was an actual Franklin Company employee.\textsuperscript{26} The Franklin Company challenged this finding, asserting that the injured worker was not part of the organized labor force with which the company had an exclusive contract because the company paid these workers through expense accounts rather than through payroll.\textsuperscript{27}

The court found that there was no clear rule for defining employment status to determine whether the worker was an independent contractor

\begin{itemize}
  \item exemptions of employees' wages from garnishment;
  \item a duty to pay minimum wage or social security taxes. \textit{See id.}
  \item \textsuperscript{23} \textit{See id.} (explaining that the shift in terminology from master and servant to employer and employee accompanied the development of workers' compensation legislation, which clearly defines the two roles). To determine the scope of the vicarious liability with regard to the relationship between the employer and employees, the definition of an employee becomes important. \textit{See id.}
  \item \textsuperscript{24} Sadler \textit{v. Henlock}, 119 Eng. Rep. 209, 212 (Q.B. 1855). \textit{Sadler} is the earliest English case employing the modern control test. Two years after \textit{Sadler}, an American state court employed the control test in \textit{Boswell v. Laird}, 8 Cal. 469 (1857). The Supreme Court first considered the right-to-control test in \textit{Railroad Co. v. Hanning}, 82 U.S. (15 Wall.) 649 (1872). The Court again articulated the right-to-control test in \textit{Singer Manufacturing Co. v. Rahn}, 132 U.S. 518 (1889). Company policy became troublesome to Singer because it reserved the right to prescribe and regulate its horse and wagon driver's business and the manner in which the driver should do it. \textit{See id.} at 523. The Court determined, therefore, that the driver was the company's servant, and because the accident occurred during the course of employment, the company was responsible for the defendant's acts. \textit{See id.} at 524.
  \item \textsuperscript{25} 129 N.E. 811 (Ill. 1921).
  \item \textsuperscript{26} \textit{See id.} at 812 (explaining that compensation was awarded under the Workmen's Compensation Act, but then set aside by the circuit court). The worker appealed and the Supreme Court of Illinois reversed and reinstated the award of workmen's compensation. \textit{See id.} at 814.
  \item \textsuperscript{27} \textit{See id.} at 813 (articulating the worker's contention that he was paid from the expense accounts but also was on the payroll for different assignments from the mine).
\end{itemize}
or an employee. Explaining that it must consider all factors of employment together, the court concluded that the principal consideration is who possesses the right to control the manner of the work performed. Defining an independent contractor as "one who undertakes to produce a given result without being in any way controlled as to the method by which he attains that result," the court classified the worker as an employee because the employer retained control over his work. Accordingly, the court awarded the employee workers' compensation.

B. 1940 to 1970: The National Labor Relations Board's Treatment of Independent Contractors and the Right-to-Control Test

Although the Wagner Act of 1935 defined "employee" very broadly thereby making independent contractors eligible for employee benefits, the National Labor Relations Board (NLRB) generally withheld benefits associated with employee status from independent contractors. In refusing to extend benefits to independent contractors, the Board invoked the right-to-control test to define employment status.

In NLRB v. Hearst Publications, Inc. the Supreme Court considered whether the right-to-control test should be the exclusive means used to classify workers as employees or independent contractors. The Hearst case arose when publishers of four Los Angeles daily newspapers refused to engage in collective bargaining with a union representing "newsboys"
because these workers were not "employees" as defined by the National Labor Relations Act (NLRA). Thereafter, the NLRB held proceedings and classified the regular full-time newspaper carriers as "employees" within the meaning of NLRA. The publishers challenged the NLRB ruling, arguing that, since Congress did not define the term "employee" specifically, courts should rely exclusively on "common-law standards" to distinguish between employees and independent contractors.

The Supreme Court, however, upheld the NLRB's characterization of the workers as "employees," rather than independent contractors. Reasoning that the broad language of the Wagner Act's definitions rejected "conventional limitations" on terms like "employee," the Court concluded that the NLRB should not rely solely on common-law standards to interpret the meaning of terms contained in the Act. Instead, the Court ruled that the NLRB should also consider the "history, terms and purposes of the legislation," along with the "underlying economic facts rather than" making a determination "technically and exclusively by previously established legal classifications."

In 1947, Congress reacted to Hearst by excluding independent contractors from the definition of employee in the Taft-Hartley Amendments. Since then, the Supreme Court has given greater deference to the NLRB's decisions regarding employment status by applying the right-to-control test. For example, in NLRB v. United Insurance Co., the Court employed the right-to-control test to determine if workers were eligible for the protections of the NLRA. The Insurance Workers Union as-

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37. See id. at 113.
38. See id. at 131.
39. See id. at 120.
40. See id. at 120, 129.
41. See id. at 124 (explaining the Act's allowance for underlying economic facts to be assessed rather than relying on the common-law "right to control" test).
42. Id. at 129.

The obvious purpose of this amendment was to have the Board and the courts apply general agency principles in distinguishing between employees and independent contractors under the Act. Thus there is no doubt that we should apply the common-law agency test here in distinguishing an employee from an independent contractor.

Id.
46. See id. at 256.
serted that debit agents, who sold insurance and collected premiums from policyholders, were employees for the purpose of filing an unfair labor practice action.47 The workers challenged their classification as independent contractors because the NLRA protected only employees, not independent contractors.48 The NLRB ruled that, under the Act, the agents were employees.49 Reviewing the Seventh Circuit’s refusal to enforce the NLRB ruling, the Court applied common-law agency principles and concurred with the NLRB finding that debit agents were employees.50

C. The 1980s: Application of the Right-to-Control Test in ERISA Cases

After encountering numerous political obstacles and much public debate, Congress enacted ERISA in 1974 in response to concerns regarding inadequacies in the existing law governing private pension systems.51

One shortcoming of ERISA is the legislation’s lack of a clear definition of “employee,” which would be useful in classifying workers as employees or independent contractors.52 ERISA defines “employee” merely as “any individual employed by an employer.”53 As one court noted, “the statutory definition thus provides little or no guidance when the question is whether a party performing services pursuant to a particular work arrangement is an employee.”54 Accordingly, litigation raising the question of whether an individual is an employee or an independent contractor for purposes of ERISA involves both an interpretation of the statute and an application of common-law principles of agency.55

In Holt v. Winpisinger,56 the United States Court of Appeals for the

47. See id. at 255.
48. See id. at 255 n.1.
49. See id. at 255.
50. See id. at 258-59 (explaining that “there is no shorthand formula or magic phrase” to determine employee status, but that all factors are assessed and weighed equally).
51. See JAY CONISON, EMPLOYEE BENEFITS IN A NUTSHELL 69-76 (1993). ERISA represents reconciliation between advocates who view pension plan law as labor legislation and others who approach it as tax legislation. See id.
53. Id.
55. See id. at 1536, 1538 & n.44 (concluding that the absence of a comprehensive definition of “employee” and other features of ERISA plainly indicate Congress’ intent to allow the Secretary of Labor to continue the longstanding practice of distinguishing between “employees” and “independent contractors” by applying common-law agency principles).
56. 811 F.2d 1532 (D.C. Cir. 1987).
District of Columbia Circuit applied the common-law right-to-control test to find an employee eligible for ERISA benefits for her entire tenure of employment. Although, the employer originally classified Holt as an independent contractor, after one year Holt became a full-time employee. Despite the reclassification, Holt's duties and all other work-related circumstances remained the same during her entire tenure of employment. A dispute arose because Holt's pension benefits did not vest until she became a full-time employee. On the date of her termination, therefore, she was one year short of pension eligibility. Applying the right-to-control test, the court found that Holt was an employee for the first year of her employment and therefore eligible for a pension.

Several years later, the Supreme Court entered the ERISA classification foray and employed the right-to-control test in Nationwide Mutual Insurance Co. v. Darden. In Darden, a former insurance agent brought

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57. See id. at 1542.
58. See id. at 1534 (explaining that after a year, Holt was hired on a full-time basis with the title of Office Manager).
59. See id. (providing that Holt performed the same tasks and reported to the same supervisor after being hired full-time).
60. See id.
61. See id. (providing that the Financial Officer received notice of Holt's full-time employment and that Holt's pension credits should start on the date she was hired as a full-time employee).
62. See id. at 1540-41 (explaining that Holt was an employee for the first year at IAM, and that this year should have been calculated into the necessary 10 years of service for entitlement to the accrued benefits).
63. 503 U.S. 318 (1992). Several years before Darden, the Supreme Court applied the right-to-control test to determine employment status in a dispute over ownership of a sculpture copyright in Community for Creative Non-Violence v. Reid, 490 U.S. 730 (1989). In Reid, two competing parties sought copyright ownership of a sculpture. See id. at 732-33. Petitioner, Community for Creative Non-Violence, entered into an oral agreement with respondent Reid, a sculptor, to obtain a statue that depicted homelessness for display at a Christmas pageant. See id. After completion of the statue, both parties filed competing copyright registration certificates for the statue. See id. The parties brought the case to determine who held the copyright. See id.

The Court used common-law agency principles to determine the sculptor's employment status in resolving the copyright issue, finding that the sculptor was an independent contractor under the right-to-control test. See id. at 731. The Court outlined the factors for the right-to-control test and weighed them equally, with no one factor being decisive. See id. at 751-52.

In determining whether a hired party is an employee under the general common law of agency, we consider the hiring party's right to control the manner and means by which the product is accomplished. Among the other factors relevant to this inquiry are the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work;
an action under ERISA to recover retirement benefits. In order for Darden to claim the proceeds of the retirement plan under ERISA, he would have to be an "employee." Relying on common-law agency principles, the Court employed the right-to-control test in determining whether Darden was an "employee" within the meaning of ERISA.

D. The Right-to-Control Test in the 1990s: Challenges to Contractual Agreements Purporting to Classify Employment Relationships

Even contractual agreements purporting to classify workers as independent contractors, rather than employees, may not prevail over the

the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party.

Id. (citations omitted).

64. See Darden, 503 U.S. at 320 (explaining that the contract between Darden and Nationwide Mutual Insurance Co. included a retirement plan that would be forfeited if Darden sold, within a year of termination, insurance for Nationwide's competitors).

65. See id. at 320-21 (stating that the district court granted Nationwide's motion for summary judgment because Darden was not a proper ERISA plaintiff because he was an independent contractor, not an employee as required by ERISA).

66. See id. at 323 (explaining that when ERISA does not clearly define "employee," the presumption is that Congress intended the common law of agency to be the test). A federal district court applied a similar test for determining employee status in EEOC v. Fawn Vendors, Inc., 965 F. Supp. 909, 910-11 (S.D. Tex. 1996). In this case, the plaintiff asserted a Title VII action alleging that Fawn Vendors subjected workers to a sexually hostile work environment and failed to take appropriate corrective action. See id. at 910. Because a successful Title VII action must involve an employment relationship, the court applied an "economic realities/common-law control" test employed by the Fifth Circuit. See id. at 911. This test includes the same factors used in Reid, and considers all factors equally. See id. The economic reality test currently applies to cases involving the Fair Labor Standards Act (FLSA) (which pertains to minimum wages and overtime pay). See Barron, supra note 4, at 460. The economic reality test gives courts a broader view of employment circumstances, focusing on the circumstances of the whole activity. See id. Barron summarized the following six factors in the economic reality test by which a worker will most likely be classified as an employee:

1. a limited amount of the worker's investment in facilities and equipment
2. the nature (close supervision) and degree of control (high) retained or exercised by the company
3. the worker's limited opportunities for profit and loss
4. the small degree of the worker's independent initiative, judgment, and foresight in open market competition with others required for the success of the operation
5. a high degree of permanency of the work relationship
6. the broad extent to which the services are an integral part of the company's business

Id. at 466-67. After weighing all of these factors, the Fawn court found the plaintiff to be an employee and not an independent contractor. See Fawn Vendors, 965 F. Supp. at 913.

factual and economic reality of the employment relationship. In *Daughtrey v. Honeywell, Inc.*, the Court of Appeals for the Eleventh Circuit employed the right-to-control test in reviewing a claim for ERISA benefits when a company classified a worker incorrectly. The court held that the contractual agreement Daughtrey signed stating that she was an independent contractor, thereby waiving all benefits provided by Honeywell to its employees, was not dispositive of her employment status. Although finding that a contractual agreement may demonstrate the parties' intent, the court concluded that Daughtrey was a Honeywell employee after reviewing all the factors under the right-to-control test.

A recent decision from the Court of Appeals for the Tenth Circuit stirs controversy over such employee agreements that essentially waive all rights to benefits. In *Capital Cities/ABC, Inc. v. Ratcliff*, newspaper carriers challenged the Kansas City Star Newspaper (owned by Capital Cities/ABC, Inc.), claiming they were eligible for ERISA benefits. The carriers challenged the publishers' denial of benefits because the IRS found that many of the carriers were common-law employees. The court held that an agency agreement, in which workers acknowledged they were not employees and were ineligible for benefits, foreclosed the workers' rights to benefits under the company's ERISA plans.

The *Capital Cities* court relied on *Boren v. Southwestern Bell Telephone Co.* In *Boren*, the plaintiff had a series of one-year service con-

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67. 3 F.3d 1488 (11th Cir. 1993).
68. See id. at 1492.
69. See id. at 1492-93 (finding employment status is not determined from the label used in the contract for purposes of ERISA).
70. See id. at 1492 (explaining that for ERISA purposes, the test employed is the common-law test articulated in *Reid*).
71. See *Capital Cities/ABC, Inc. v. Ratcliff*, 141 F.3d 1405 (10th Cir. 1998).
72. 141 F.3d 1405 (10th Cir. 1998).
73. See id. at 1408 (explaining that a group of carriers in 1991 formally requested ERISA benefits under the Kansas City Star's four ERISA plans).
74. See id. After an audit in 1991, the IRS issued a Technical Advice Memorandum concluding that, under the right-to-control test, many of the newspaper carriers were common-law employees of the Kansas City Star. See id. The IRS later retracted this determination. See id. at 1408 n.2. The factual situation in *Capital Cities* is very similar to *Vizcaino*, where workers filed a class action for ERISA benefits after the IRS determined that the workers were employees.
75. See id. at 1405.
76. See id. at 1409 (refuting the assertion that *Boren* was overruled by *Darden*). The *Capital Cities* court held that service contracts define the relationship between employer and worker and determine the rights of the parties accordingly. See id.
77. 933 F.2d 891 (10th Cir. 1991).
tracts with Southwestern Bell for a twenty-five year tenure.\textsuperscript{78} The service contracts were silent on the issue of employee status for the first twelve years.\textsuperscript{79} For the most recent thirteen years, the service contracts specifically referred to the plaintiff as an independent contractor and stated that he was not an employee "for any purpose."\textsuperscript{80} Hence, the \textit{Boren} court did not apply the right-to-control test because it found that the service contracts between the parties defined their relationship and determined the rights regarding ERISA benefits.\textsuperscript{81} The court held, therefore, that the express terms of the employment contract, in which the plaintiff agreed he was not an employee, prevented him from claiming ERISA benefits.\textsuperscript{82}

In addition to \textit{Boren}, the \textit{Capital Cities} court also relied on \textit{Bronk v. Mountain States Telephone and Telegraph, Inc.},\textsuperscript{83} which provided that employers may exclude certain employees from their benefits plans.\textsuperscript{84} In \textit{Bronk}, leased employees brought an ERISA action for wrongful denial of participation in benefit plans.\textsuperscript{85} Determining that ERISA regulations did not require the employer to include leased employees in the benefit plan,\textsuperscript{86} the court explained that ERISA regulations are meant to determine whether a plan qualifies for preferential tax status, and not to force companies to include all common-law employees in their plans.\textsuperscript{87}

\textsuperscript{78} See id. at 892 (explaining that the series of one-year contracts between Boren and Southwestern Bell were for architectural supervision services).

\textsuperscript{79} See id.

\textsuperscript{80} See id. The carriers argued that \textit{Boren} was overruled by \textit{Nationwide Mutual Insurance Co. v. Darden}, 503 U.S. 318 (1992). \textit{See Capital Cities}, 141 F.3d at 1409. The \textit{Capital Cities} court explained that \textit{Darden} merely held that the right-to-control test determines only employee status for ERISA benefits, not that any worker meeting this determination is entitled to ERISA benefits. \textit{See id.} The court further found that not all common-law employees must receive coverage from their employer. \textit{See id.}

\textsuperscript{81} \textit{See Boren}, 933 F.2d at 894.

\textsuperscript{82} See id.

\textsuperscript{83} 140 F.3d 1335 (10th Cir. 1998).

\textsuperscript{84} \textit{See Capital Cities}, 141 F.3d at 1409.

\textsuperscript{85} \textit{See Bronk}, 140 F.3d at 1336 (providing that the leased employees justified their entitlement to the pension and welfare benefits because they performed "same or similar" functions as employees).

\textsuperscript{86} \textit{See id.} at 1338 (explaining that ERISA allows an employer to distinguish between groups or categories of employees, including providing benefits to only a select group).

\textsuperscript{87} \textit{See id.} at 1339 ("Code provisions do not require ERISA plans to include leased employees; they merely require employers to take leased employees into account in showing that their plans meet the nondiscriminatory coverage requirements of the Code.").
II. VIZCAINO V. MICROSOFT: FORMER INDEPENDENT CONTRACTORS SUE FOR EMPLOYEE BENEFITS

A. Origin of the Dispute: Workers Sign Independent Contractor Agreements at Time of Hire to Obtain Higher Salaries Instead of Benefits

In Vizcaino, eight workers brought a class action against Microsoft Corporation claiming that they were entitled to savings benefits under the Savings Plus Plan (SPP) and stock options benefits under the Employee Stock Purchase Plan (ESPP). Microsoft asserted that the workers were independent contractors and consequently denied the workers' claim to participation in the SPP and ESPP. Microsoft employed the Vizcaino plaintiffs as freelance workers before 1990 to perform various services including production editing, proofreading, and formatting. The plaintiffs performed these services for continuous periods. At the time of hire, each plaintiff had signed an agreement explicitly foregoing benefits from Microsoft. Microsoft later integrated the plaintiffs and other freelance workers into the corporate workforce, making several distinctions between the independent contractors and the employees. One of the major distinctions was that the independent contractors submitted invoices to the Ac-
counts Payable department for their paychecks instead of submitting their time sheets to the Payroll department. In 1989 and 1990, the IRS examined Microsoft’s employment records and concluded that the company’s independent contractors were actually common-law employees. Microsoft complied with the IRS determination by issuing W-2 forms to the former “independent contractors” and paid the employee’s share of their FICA taxes.

After complying with the IRS decision, Microsoft changed its system for the freelance workers. Microsoft offered some freelance workers permanent employee positions, while offering the remaining workers the opportunity to work for a temporary employment agency that supplied workers to Microsoft on an as-needed basis. Some of the freelance workers sued Microsoft, claiming entitlement to the SPP and ESPP benefits based on the IRS decision and the fact that the two benefit plans were available to employees.

I. Vizcaino I

In Vizcaino I, the district court referred the matter to a magistrate judge following cross-motions for summary judgment. The magistrate judge recommended an award in favor of the plaintiffs on the SPP and ESPP benefit plans’ issues. The district court did not adopt the magistrate judge’s recommendation in its entirety, however, and granted Microsoft’s motion for summary judgment.

The Court of Appeals for the Ninth Circuit reversed the district court.

95. See id. ("[T]hey were not paid through Microsoft’s payroll department. Instead, they submitted invoices for their services, documenting their hours and the projects on which they worked, and were paid through the accounts receivable department.").

96. See id. (stating that the IRS applied common-law principles to determine that the independent contractors were actually employees, and that Microsoft should have been withholding taxes and paying certain taxes for these workers).

97. See id. at 1190-91.

98. See id. at 1191.

99. See id. Microsoft tendered offers to those workers who remained in essentially the same relationship as before the reclassification. See id. The other workers had the opportunity to work for the temporary employment agency that supplied workers to Microsoft. See id.

100. See id.; Vizcaino v. Microsoft, 120 F.3d 1006, 1009 (9th Cir. 1997) (en banc) (Vizcaino II) (explaining that a panel was convened which ruled that “the Workers were not entitled to any benefits from . . . the SPP—or . . . the ESPP . . . because the [w]orkers had agreed that they were independent contractors and because they had waived the right to participate in benefit plans." Id.

101. See Vizcaino I, 97 F.3d at 1191.

102. See id.

103. See id. at 1192.
and determined that the workers should participate in the SPP and ESPP plans.\(^{104}\) For the SPP plan, Microsoft contended that the workers were not eligible to participate because they were not on the payroll.\(^{105}\) ERISA regulations govern SPP plans and require all employees "on the United States payroll of the employer" to be eligible for participation in such plans.\(^{106}\) The court looked to the terms of Microsoft’s SPP plan and other manifestations of intent (extrinsic evidence) to interpret its provisions.\(^{107}\)

The court found the terms of the plan ambiguous and concluded that, but for the erroneous misclassification, Microsoft would have intended to give the workers employee benefits.\(^{108}\) Regardless of whether the workers were paid through the payroll account or accounts payable, the court concluded that ERISA regulations entitled the workers to participate in the SPP.\(^{109}\)

The court also determined that Microsoft improperly excluded the workers from participation in the ESPP,\(^{110}\) which permitted all regular employees to participate.\(^{111}\) The workers were therefore entitled to participate based on the IRS ruling that Microsoft mistakenly classified the workers as independent contractors rather than employees.\(^{112}\)

2. Vizcaino II: Rehearing En Banc

After Vizcaino I, Microsoft petitioned the Court of Appeals for the Ninth Circuit for a rehearing en banc.\(^{113}\) Sitting en banc, the Ninth Cir-
court found the workers eligible for benefits under the SPP because they were employees (as now conceded by Microsoft) and not independent contractors.\textsuperscript{114}

The workers' participation in the SPP was subject, however, to their being "on the United States payroll of the employer."\textsuperscript{115} The court determined that the plan administrator has the primary duty of construing the phrase, "on the United States payroll of the employer."\textsuperscript{116} This finding overruled the Vizcaino I three-judge panel's decision that the court could have the primary duty of construing this phrase.\textsuperscript{117} The court directed the plan administrator to determine whether the workers were entitled to participate in the SPP based on his or her construction of the phrase.\textsuperscript{118} In Vizcaino II, the court determined the SPP was an ERISA plan.\textsuperscript{119}

For participation in ESPP, the court agreed generally with the Vizcaino I panel's finding.\textsuperscript{120} In contrast, however, the court determined that the workers could have accepted the contract without knowing the precise terms of the plan.\textsuperscript{121} The court remanded the ESPP issues to the district court and the SPP issues to the plan administrator.\textsuperscript{122} Microsoft's plan administrator determined that the workers were not entitled to SPP

(Vizcaino II).

\textsuperscript{114} See id. at 1013 (reiterating that Microsoft's decision to deny participation to the workers based upon the "supposed independent contractor status of the Workers" was wrong (which Microsoft conceded)).

\textsuperscript{115} See id. ("We are asked to decide what is meant by the SPP's restriction of benefits to common-law employees who are 'on the United States payroll of the employer.'").

\textsuperscript{116} See id. The court insisted that it would not "be seduced into making a decision which belongs to the plan administrator in the first instance." Id.

\textsuperscript{117} See id. (encouraging the "dumping of difficult and discretionary decisions into the laps of the courts" despite one of the purposes of ERISA being to avoid courts taking the time and effort to resolve such issues).

\textsuperscript{118} See id. (stating that the court would set poor precedent if it was to decide the issue of plan construction before the plan administrator had a chance to consider the issue and rule on it).

\textsuperscript{119} See id. at 1013.

\textsuperscript{120} See Short, supra note 108, at 408. In Vizcaino I, the court held that the workers were covered under the ESPP because the court "applied the 'objective manifestation theory of contracts,' which requires imputation of 'an intention corresponding to the reasonable meaning of a person's words and acts.'" Id. (quoting Vizcaino v. Microsoft Corp., 97 F.3d 1187, 1196 (9th Cir. 1996) (Vizcaino I)). The court found in Microsoft's plan documents an objective intent to make all common-law employees eligible for participation. See id. at 409. The workers, therefore, were eligible because they were common law employees. See id. The court on rehearing en banc agreed with this finding that the workers were eligible for the ESPP. See Vizcaino II, 120 F.3d at 1014-15.

\textsuperscript{121} See Vizcaino II, 120 F.3d at 1014 (remanding to the district court for a determination of an appropriate remedy).

\textsuperscript{122} See id. at 1015.
benefits because they were independent contractors. Thereafter, the court reviewed the denial of benefits to decide whether Microsoft’s decision was arbitrary or capricious.

The court found that Microsoft’s decision to deny benefits was arbitrary and capricious because the corporation based its decision on an erroneous application of the workers’ classification. The court remanded the case to the plan administrator to reconsider the workers’ claims, specifically their eligibility for the SPP benefits.

B. Five Separate and Distinct Opinions

Fourteen judges took part in formulating the final Vizcaino decision, producing five distinct opinions on appeal. There are two majority opinions, two dissents (one with a partial concurrence), and one concurring opinion with a partial dissent between the original three-judge panel and the eleven judges hearing the case en banc.

The majority decision by the Ninth Circuit in Vizcaino I denied Microsoft the right to contract with freelance workers in order to exclude them from the benefits available to its employees. The court sitting en banc, however, dismissed this clearly-stated rule by assuming Microsoft did not intend to exclude the freelance workers from the benefit plans; instead, the court held that Microsoft mistakenly believed that the workers were independent contractors rather than employees. As a result, although worker misclassification accounted for the genesis of the dispute in Vizcaino, the Ninth Circuit never reached the question of whether the freelance temporary workers were actually employees because Microsoft conceded the issue. Thus, Vizcaino does not help clarify the law or

123. See id. at 1013.
124. See id.
125. See id.
126. See id. at 1014 (explaining that the determination for eligibility of SPP benefits is a new issue for the plan administrator and should, therefore, first be decided by the plan administrator and then be reviewed by the court).
127. See Alvin D. Lurie, Microsoft Gets Due-Processed in Federal Court, 76 Tax Notes 1633, 1633 (1997).
128. See id.
129. See id.
130. See id. (concluding that the en banc majority “punted, mooting the central issue of exclusion-by-contract by assuming that Microsoft obviously would have meant to exclude the plaintiffs from its benefit plans if it had only realized that they were truly its common-law employees”).
131. See Vizcaino II, 120 F.3d at 1010 (explaining that the en banc court did not consider the issue of whether the workers were “employees” in Vizcaino II because “both Microsoft and the SPP have conceded . . . that the Workers were common law employees”).
provide guidance to industries in classifying workers. On the contrary, the case highlights the potential consequences of misclassification.

III. IMPLICATIONS OF VIZCAINO II ON QUALIFYING CORPORATE PENSION PLANS

ERISA regulations provide employees with federal statutory protection from employer abuses of private pension systems. Congress enacted ERISA to protect employees from corrupt management of pension plans and to prevent exclusion of certain employees from benefits plans.

ERISA regulations create incentives that help protect Microsoft workers because the SPP plan entitles Microsoft to considerable tax savings. In order for Microsoft to receive tax preferential treatment, however, the corporation’s SPP plan must meet the requirements for a qualified plan. These requirements ensure minimum participation standards and

132. See Lurie, supra note 127, at 1633 (explaining that the worker classification question of whether the plaintiffs were employees or independent contractors was an important issue in the case). The worker classification issue was not resolved because the majority noted that Microsoft conceded that the workers were employees for the purposes of the appeal. See id. Therefore, “the case has decided very little of importance to the development of the law or for the guidance of high-tech electronics and service industries.” Id. This also influences other industries using part-time workers, leased employees and contingent labor providers. See id. The Teamsters’ UPS strike also brought the increasing use of a part-time workforce to the public’s attention. See id. However, the “payroll” issue may be reviewed further. See id. at 1634. On remand, the district court could give “on the United States payroll of the employer” a broad interpretation, as the three-judge panel did in Vizcaino I. See id. If the Ninth Circuit Court of Appeals were to affirm that decision, then there could potentially be a conflict with the Fourth Circuit’s unpublished contrary decision in Clark v. E.I. DuPont DeNemours, No. 95-2845 (4th Cir. 1997) (per curiam). See id.

133. See ROSE & CHOMMIE, supra note 10, at 254. ERISA protects workers by limiting an employer’s ability to impose eligibility requirements and requiring employees to have a non-forfeitable right to the benefit package after a predetermined number of years of participating in the plan. See id. The legislation also requires minimum funding standards to assure financial soundness of the plan and imposes fiduciary standards on the trustees of the plan. See id. ERISA mandates certain reporting and disclosure requirements on employers and establishes a plan insurance agency, the Pension Benefit Guaranty Corporation. See id.

134. See id. at 255. ERISA prescribes employers from establishing benefit plans only for officers, directors, and other highly compensated employees, while leaving out the lower paid workers. See id. Without ERISA, most workers would not have a pension from their employer. See id. Congress wanted to prevent this result by enacting the Internal Revenue Code provisions for qualifying a pension plan for tax beneficial status. See id.

135. See I.R.C. § 401(a) (Supp. 1999) (requiring that a trust that is created or organized within the United States that forms a stock bonus, pension, or profit-sharing plan of an employer that exclusively benefits the employer’s employees, must meet certain requirements to constitute a qualified trust).
non-discriminatory allocation of eligibility.\textsuperscript{136}

Misclassification can disqualify a pension plan if the plan does not meet the numerical eligibility test.\textsuperscript{137} When courts or regulators find that independent contractors are common-law employees, disqualification may occur because the employer failed to include the formerly misclassified workers in the test qualifying the plan.\textsuperscript{138} The Supreme Court could easily resolve this conflict by providing clarification and guidance for employers.\textsuperscript{139}

\textbf{A. Requirements for Qualifying a Pension Plan under ERISA}

Under IRS regulations, pension, profit sharing, and stock-bonus plans must meet certain requirements for qualification.\textsuperscript{140} These pension plans are established primarily to provide employees with retirement

\begin{itemize}
\item \textsuperscript{136} See I.R.C. § 401(a)(3)-(4) (Supp. 1999) (providing that a plan is a qualified trust "if the plan of which such trust is a part satisfies the requirements of section 410 (relating to minimum participation standards)" and "if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of 414(q))").
\item \textsuperscript{137} See Kelley, \textit{supra} note 7, at 101 & n.34 (stating that misclassification of workers may result in numerous violations of the qualifying rules for ERISA).
\item \textsuperscript{138} See Timothy J. Snyder, \textit{Bulletproof Your Qualified Plans}, DEL. EMPLOYMENT L. LETTER, May 1998 (urging employers to "[m]ake sure that all workers who are eligible to participate in the plan do so"). There is a "plethora" of ways the qualification provision can be violated. \textit{See id.} The first is by misclassifying workers as independent contractors and excluding them from participation in the pension plan. \textit{See id.} A company may, however, exclude independent contractors from its plan if the plan provides specifically that independent contractors may not participate. \textit{See id.} Notwithstanding, the plan must still meet the coverage tests under ERISA with the independent contractors excluded. \textit{See id.}
\item \textsuperscript{139} See Lurie, \textit{supra} note 127, at 1634 (explaining that if there was a conflict between the Ninth Circuit Court of Appeals and the Fourth Circuit Court of Appeals on the "pay-roll" issue, the Supreme Court would have the "jurisdictional hook needed for certiorari").
\item \textsuperscript{140} See I.R.C. § 401(a)(1)-(4) (Supp. 1999).
\end{itemize}
The first requirement of a qualified plan involves defining a

A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404(a)(3)(B) (relating to deduction for contributions to profit-sharing and stock bonus plans), or by a charitable remainder trust pursuant to a qualified gratuitous transfer (as defined in section 664(g)(1)), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries (but this paragraph shall not be construed, in the case of a multiemployer plan, to prohibit the return of a contribution within 6 months after the plan administrator determines that the contribution was made by a mistake of fact or law (other than a mistake relating to whether the plan is described in section 401(a) or the trust which is part of such plan is exempt from taxation under section 501(a), or the return of any withdrawal liability payment determined to be an overpayment within 6 months of such determination));

(3) if the plan of which such trust is a part satisfies the requirements of section 410 (relating to minimum participation standards); and

(4) if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of section 414(q)).

For purposes of this paragraph, there shall be excluded from consideration employees described in section 410(b)(3)(A) and (C).

Id.

141. See Treas. Reg. § 1.401-1(b)(1)(i) (as amended in 1976). This regulation provides:

A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants (see § 1.401-7, relating to the treatment of forfeitures under a qualified pension plan). A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of section 401(a), be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, as in the case of money purchase pension plans, such contributions are fixed without being geared to profits. A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or
The plan, maintained by an employer, is a written program and arrangement communicated to the employees. Employees' eligibility for participating in a pension plan is determinative of a qualified plan. Qualified plans may not require as a condition of participation a term of service of more than one year or a requirement to remain a member beyond the date the employee reaches age twenty-one. If an employee satisfies the minimum service requirement or minimum age, the employee must start participating, beginning on the date the employee satisfied the requirement or within six months of that date.

The IRS designed eligibility tests to ensure that employers extend benefit plans to rank-and-file employees, so that most workers would be covered by private pension plans. Numerical eligibility tests define the number and percentage of a workforce that employers need to include in

benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401-14).

Id.

142. See ROSE & CHOMMIE, supra note 10, at 259; see also Treas. Reg. § 1.401-1(a)(2) (as amended in 1976) (defining a plan as "a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer").

143. See Treas. Reg. § 1.401-1(a)(2) (as amended in 1976) (providing the definition of qualified pension plans, profit-sharing plans, and stock bonus plans).

144. See ROSE & CHOMMIE, supra note 10, at 262.


A trust shall not constitute a qualified trust under section 410(a) if the plan of which it is a part requires, as a condition of participation in the plan, that an employee complete a period of service with the employer or employers maintaining the plan extending beyond the later of the following dates—

the date on which the employee attains the age of 21;

or the date on which he completes 1 year of service.

Id.; see also I.R.C. § 410(a)(1)(B)(i) (1998) (providing an exception when the plan provides a two-year service requirement if the employee is 100% vested after two years of service).


A plan shall be treated as not meeting the requirements of paragraph (1) unless it provides that any employee who has satisfied the minimum age and service requirements specified in such paragraph, and who is otherwise entitled to participate in the plan, commences participation in the plan no later than the earlier of—

(A) the first year of the first plan year beginning after the date on which such employee satisfied such requirements, or

(B) the date 6 months after the date on which he satisfied such requirements, unless such employee was separated from the service before the date referred to in subparagraph (A) or (B), whichever is applicable.

Id.; see also ROSE & CHOMMIE, supra note 10, at 262.

147. See ROSE & CHOMMIE, supra note 10, at 255 (explaining that employers may extend benefit plans only to officers, shareholders, and highly compensated employees).
the pension plan to achieve qualified status. The numerical tests provide that either at least seventy percent of all employees must benefit from the plan, or at least eighty percent of all employees eligible to benefit must participate (provided that seventy percent of all employees are eligible to benefit from the plan).

An alternative test requires a "fair cross section" of employees in salary ranges to participate in the plan. This test has special rules regarding the highly compensated employees in addition to the rules regarding discrimination. The Tax Reform Act of 1986 changed the rules for


149. See ROSE & CHOMMIE, supra note 10, at 262 (explaining that certain employees may be excluded from a numerical eligibility test for determining qualifications in a benefits plan). The excluded employees usually are those who did not satisfy the plan's minimum service or age conditions. See id. Therefore, these numerical tests are calculated based on the number of employees after exclusions. See id.

150. See Treas. Reg. § 1.410(b)-1(d)(2) (as amended in 1993). The regulations provide:

Discrimination. The determination as to whether a plan discriminates in favor of employees who are officers, shareholders, or highly compensated is made on the basis of the facts and circumstances of each case, allowing a reasonable difference between the ratio of such employees benefited by the plan to all such employees of the employer and the ratio of the employees (other than officers, shareholders, or highly compensated) of the employer benefited by the plan to all employees (other than officers, shareholders, or highly compensated). A showing that a specified percentage of employees covered by a plan are not officers, shareholders, or highly compensated, is not in itself sufficient to establish that the plan does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

Id.


Special rules—(1) Highly compensated. The classification of an employee as highly compensated for purposes of section 410(b)(1)(B) and § 1.410(b)-1(b)(2) is made on the basis of the facts and circumstances of each case, taking into account the level of the employee's compensation and the level of compensation paid by the employer to other employees, whether or not covered by the plan. Average compensation levels determined on a local, regional, or national basis, are not relevant for this purpose. Further, the classification of an employee as highly compensated is not made solely on the basis of the number or percentage of employees whose compensation exceeds, or is exceeded by, the employee's.

Id.; see also I.R.C. § 414(q)(1) (1998) (defining the term highly compensated employee):
participation tests for plan years beginning after December 31, 1998.\textsuperscript{152}

\textbf{B. Careful Preparation Can Alleviate Liability: How to Avoid Misclassification Problems}

After \textit{Vizcaino II}, employers must take great care in identifying accurately, from the hiring date, whether the worker is an employee or an independent contractor.\textsuperscript{153} Businesses should also use preventive meas-

The term "highly compensated employee" means any employee who—
(A) was a 5-percent owner at any time during the year or the preceding year, or
(B) for the preceding year—
   (i) had compensation from the employer in excess of $80,000, and
   (ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year.

The Secretary shall adjust the $80,000 amount under subparagraph (B) at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter ending September 30, 1996.

\textit{Id.} \textsuperscript{152} See Treas. Reg. \textsection 1.410(b)-1(b) (as amended in 1993):
\textit{Coverage tests}---(1) \textit{Percentage test}. A plan satisfies the requirements of this subparagraph if it benefits—
   (i) seventy percent or more of all employees, or
   (ii) eighty percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan,

excluding in each case employees who have not satisfied the minimum age and service requirements (if any) prescribed by the plan, as of the date coverage is tested, as a condition of participation and employees permitted to be excluded under paragraph (c) of this section. The percentage requirements of this subparagraph refer to a percentage of active employees, including employees temporarily on leave, such as those in the Armed Forces of the United States, if such employees are eligible under the plan.

\textit{Id.}; see also ROSE \& CHOMMIE, supra note 10, at 262-63. The three alternate coverage tests are: (1) the plan must benefit 70% of all non-highly compensated employees; (2) the percentage of non-highly compensated employees benefiting under the plan must be at least 70% of the percentage of highly compensated employees benefiting under the plan; (3) average benefit percentage of non-highly compensated employees must be at least 70% of that for the highly compensated employees. \textit{See id.; see also} I.R.C. \textsection 401(a)(26)(A) (providing that a trust must benefit the lesser of 50 employees or more than 40% of all employees).

\textsuperscript{153} See LEWIS AND ROCA, L.L.P., \textit{When IRS Says Independent Contractors are Common-Law Employees, Benefits Liability May Follow}, 3 ARIZ. EMPL. L. LETTER 416, 418 (1996), \textit{available in LEXIS, Labor, News & Information Library} (finding the message to employers from \textit{Vizcaino II} is "without a doubt" the need for correctly classifying workers). Potential liabilities for classifying workers incorrectly include employee taxes, such as FICA and other withholdings, and employee benefits. \textit{See id.} The liabilities are significant because the hiring of independent contractors may have been for the purpose of avoiding the higher payments associated with employee benefits. \textit{See id.; see also} DENLINGER, ROSENTHAL \& GREENBERG, \textit{Partners and Contractors: Your "Employees" Under Labor and Employment Laws?}, 2 OHIO EMPL. L. LETTER, Feb. 1997, \textit{available in WESTLAW, 8 No. 2 SMOHEMPLL 2; FELHABER, LARSON, FENLON \& VOGT, P.A.,
Preventive measures include waivers, clear and unambiguous plan documents, consistent language in all company literature, utilizing different pay structures for distinct categories or workers, and hiring through temporary leasing agencies. A section 530 defense, which is a payroll tax liability provision enacted as part of the Revenue Act of 1978, and self-correction of the plan are two solutions to correct classification problems that arise.

1. Preventive Measures

In *Vizcaino II*, the court did not decide the issue regarding the agreements the workers signed waiving their rights to benefits. One criticism of this decision is that the court failed to take the opportunity to confront the issue of the validity of waivers of federally regulated benefits. The Court of Appeals for the Ninth Circuit did not decide this issue because


154. See Wheaton, supra note 88, at 9H (explaining that employers having contingent workers, including independent contractors, need to learn to manage associated risks). An enormous liability is not necessarily the employment taxes, but the cost of providing employee benefits retroactively. See id. Furthermore, the risks include disqualification of a retirement plan. See id.

155. See id. (providing ten steps for minimizing the risks of misclassification). These steps are:

1. Determine what plans exist . . .
2. Define eligibility and benefits for contingent workers . . .
3. Define when a status change occurs and what happens . . .
4. Address benefits by contract before engaging independent contractors or leased employees . . .
5. Coordinate plans, summary plan descriptions, insurance policies, employee handbooks and internal policies . . .
6. Provide broad claims procedures which incorporate 'discretionary' authority . . .
7. Monitor legislative and judicial developments . . .
8. Prepare considered responses to requests for information and claims denials . . .
9. Reserve the right to amend, modify and terminate plans . . .
10. Determine the fiduciaries and their duties . . .

Id.

156. See Lurie, supra note 17, at 1363; see also C. Frederick Reish and Bruce L. Ashton, *Self-Correction of Plan Defects Under the Service's New Administrative Policy*, 87 J. TAX'N 182, 182 (1997).

157. See *Vizcaino v. Microsoft Corp.*, 120 F.3d 1006, 1012-13 (9th Cir. 1997) (en banc) (*Vizcaino II*) (explaining that a waiver analysis would not apply to the agreements, and that Microsoft agreed that this was not a waiver case).

158. See *Recent Case*, 111 HARV. L. REV. 609, 612 (1997) (noting that the *Vizcaino II* court failed to confront the issue of waiving federally regulated benefits).
waivers must be intentional and knowing. Workers incorrectly classified cannot know they qualify for benefits; therefore, they cannot make a knowing waiver.159

One solution to the knowledge requirement attending waivers is for the employer to include clear language in the plan document regarding the specific benefits to which the independent contractor is entitled.160 A clear reflection of the intention of the parties may alleviate confusion if the independent contractor is later reclassified as a common-law employee.161 Although intent is only one factor considered by courts applying the right-to-control test, this provision will enable the courts to assess intent clearly.162

The Vizcaino II court, placing great weight on plan documents,163 warns employers to draft benefit plan documents carefully.164 Microsoft’s SPP plan document granted the plan administrator discretion to construe the terms of the plan and determine eligibility.165 On remand, the Ninth Circuit instructed the plan administrator to determine whether workers were eligible for the benefits in question.166

Plan documents should specify the eligible participants.167 This way, courts would not mistake the company’s intent to exclude independent contractors from the benefits' plans.168 With regard to the ESPP, the terms of the plan indicated that Microsoft intended to make all common-law employees eligible for participation.169 If the plan documents excluded all workers classified as independent contractors, Microsoft may

159. See id. (emphasizing that knowledge and intent are particularly important elements in federal benefits law).
160. See Short, supra note 108, at 411 (providing that plan language should also address the eligibility of an independent contractor reclassified as a common-law employee).
161. See id.
162. See id. (suggesting an employer should include a provision that cash payments are the sole compensation for independent contractors, even if reclassified as common-law employees to ensure the intent of the parties is clear).
163. See id.
164. See id. (explaining that the most relevant aspect of Vizcaino II is the emphasis the court places on the plan documents).
165. See Vizcaino v. Microsoft Corp., 120 F.3d 1006, 1013 (9th Cir. 1997) (en banc) (Vizcaino II).
166. See id. at 1014-15.
167. See Short, supra note 108, at 411 (explaining that the SPP defined eligible participants too broadly, so as not to exclude independent contractors explicitly).
168. See id.
169. See id. (explaining that the ESPP document incorporated the Code provisions; therefore, the court relied on this incorporation in finding that Microsoft intended to make common-law employees (including the freelance workers) eligible to participate).
have avoided its problems.\textsuperscript{170}

Companies should also specify the categories of workers, not only in plan documents, but also in all firm literature and contracts in order to assist management.\textsuperscript{171} This suggestion, however, does not provide complete immunity from worker misclassification because the language of documents and agreements will not prevail over the reality of the actual employment relationship.\textsuperscript{172}

Employers should also focus on pay structure, distinguishing pay structures for independent contractors from those of full-time employees.\textsuperscript{173} Using different departments to pay employees, such as the payroll department and accounts receivable, establishes the parties' intent and emphasizes the difference between full-time employees and temporary workers.\textsuperscript{174} The proper use of temporary employment agencies may help distinguish independent contractors from employees. For instance, in the situation that gave rise to \textit{Vizcaino}, Microsoft dealt with its cyclical need for workforce augmentation by using a temporary employment agency to supplement its core of permanent employees on an as-needed basis.\textsuperscript{175}

Ideally, Microsoft should have originally engaged its supplemental work force from a third-party leasing company that exercised genuine supervision over the workers, including hiring and firing.\textsuperscript{176} A pitfall of the leasing arrangement is that a company can still lose its tax preferential status if the leased workers constitute actual employees.\textsuperscript{177} Hence, the employer needs to establish an authentic third-party leasing arrangement—one that commits the control and manner of the off-payroll

\textsuperscript{170} See id.

\textsuperscript{171} See Renate M. deHaas, \textit{Employee Benefits}, \textit{Vizcaino v. Microsoft}, 13 BERKELEY TECH. L.J. 483, 498 (1998). Once the proper language is used to establish definite categories of employment, deHaas suggests using the chosen language uniformly in all contracts and agreements, avoiding any ambiguity. See id.

\textsuperscript{172} See id. at 498-99 (explaining that it is not expensive or difficult to implement differentiated language for independent contractors in company literature).

\textsuperscript{173} See id. at 498.

\textsuperscript{174} See id. (indicating that even though Microsoft was not protected by paying some workers through accounts payable expenses, while paying employees through payroll, doing so could protect other companies when the courts assess all factors together).

\textsuperscript{175} See \textit{Vizcaino v. Microsoft Corp.}, 120 F.3d 1006, 1009 (9th Cir. 1997) (en banc) (\textit{Vizcaino II}); Lurie, \textit{supra} note 17, at 1359, 1360-61.

\textsuperscript{176} See Lurie, \textit{supra} note 17, at 1360-61 (explaining that Microsoft should have originally engaged the workers under bona-fide, third-party leasing arrangements).

\textsuperscript{177} See Bronk v. Mountain States Tel. & Tel., Inc., 140 F.3d 1335, 1138-39 (10th Cir. 1998) (finding that employers are not required to provide benefits to leased employees, but that leased employees are taken into account in showing that a company's plan meets the nondiscriminatory coverage requirements of the Code).
workers' performance to the leasing agency.\textsuperscript{178} Such an arrangement may have conferred sufficient indicia of independent contractor status on the supplemental workers to allow Microsoft to withstand an IRS challenge.\textsuperscript{179}

2. Defensive Measures

Formerly, an employer could be exempt from the tax liabilities resulting from worker reclassification if the employer relied on a prior judicial or administrative ruling in classifying the worker; if a recent tax audit did not result in reclassification; or if ordinary industry practice involved classifying workers as independent contractors.\textsuperscript{180} Using this shield, known as the section 530 defense, allows for relief of payroll tax liability, but will not cure the problems associated with qualifying the pension plan for tax preferential status.\textsuperscript{181} Recently, Congress enacted the Small Business Protection Act of 1996, which modifies the section 530

\textsuperscript{178} See Lurie, supra note 17, at 1360-61.

\textsuperscript{179} See id. (cautioning that a leasing company would need to retain real powers over its leased workers, and not just ornaments of control). The IRS would then find the employer-employee relationship between the leasing company and the employee.

\textsuperscript{180} See id. at 1363 (noting that the purpose of section 530 is to insulate certain employers from payroll tax liabilities because they have relied on a prior judicial or administrative ruling, a tax audit, or industry custom).

\textsuperscript{181} See id. (explaining that section 530 is applicable only to the disposition of payroll tax issues).
defense. The modifications primarily benefit employers. Corporations can take advantage of the recently issued IRS Administrative Policy Regarding Self-Correction (APRSC) to correct plan disqualification. The APRSC allows plan sponsors the opportunity to make retroactive corrections of eligible plan defects without notice to the IRS and without penalty. A limitation of APRSC is that the employer

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182. See id. (explaining that section 530 of the Revenue Act of 1978 was intended to be “an interim solution” for disputes between the IRS and employers over payroll tax liabilities). Section 530 was extended several times and in 1982 given an “indefinite extension.” See id. The enactment of the Small Business Protection Act of 1996 reshaped the way in which section 530 will work, primarily to the benefit of employers. See id.; see also Small Business Act: S Corporation Relief and Pension Plan Reform, J. Acct., Nov. 1996, at 25 (providing that the intent of the Revenue Act of 1978 was to provide relief to employers by prohibiting the IRS from imposing liability on an employer when the IRS reclassified an independent contractor as an employee if the employer reasonably treated the individual as an employee). Because the IRS took harsh positions on the interpretation of the Revenue Act of 1978, the Small Business Protection Act of 1996 created modifications to lower the number of disputes between the IRS and employers over classification of workers. See id. The four modifications are:

1. Reclassification relief even if the IRS had not previously determined the worker was a common-law employee.
2. Shifting the burden of proof to the IRS when employers have established sufficient evidence that it was reasonable not to treat a worker as an employee.
3. Enacting a safe-harbor provision for industry practices when 25% of the industry followed the same classification approach.
4. Changing the safe harbor for audits beginning after December 31, 1996, to include an examination (for employment tax purposes) of worker classification.

Id.

183. See Lurie, supra note 17, at 1363-64 (explaining that the Small Business Protection Act of 1996 trimmed the prior audit defense when the audits began after December 31, 1996, but reaffirmed the ability to rely on prior audits that began before January 1, 1996).

184. See Reish & Ashton, supra note 156, at 182 (providing that the IRS Employee Plans Division released the APRSC in December 1996 to its essential district offices to replace the little-used Administrative Policy Regarding Sanctions).

185. See id. (explaining that self-correction allows a corporation to essentially requalify a benefits plan without IRS involvement). The limitation, however, is that self-correction is available only in the following two circumstances:

Virtually any eligible defect, no matter how serious, may be corrected under APRSC during the first plan year after the defect occurs so long as the plan is not under IRS examination. This is referred to as the “Self-Correction Procedure” (SCP).

Defects that are “insignificant” are considered to be “nondisqualifying defects” and may be corrected at any time (both before and during an IRS examination). This portion of the Policy has been labelled the “Insignificant Defect Procedure” (IDP).

Id. (citations omitted).

There is no fixed criteria for determining whether a defect is insignificant, but the following seven factors are applied to a facts-and-circumstances test:

1. The number of violations during the period under examination.
can correct the defect only if the plan is not under IRS examination. \(^{186}\)

Eligibility for APRSC requires that the qualifying benefits’ plans establish practices and procedures designed to promote and facilitate compliance with § 403(b) and § 401(a) of the Internal Revenue Code. \(^{187}\) Additionally, the violation that the employer seeks to correct must occur by mistake or oversight in applying the terms of the plan. \(^{188}\) APRSC can be very helpful as a preventive measure, if the employer finds the defect or misclassification within the first year after it occurs. \(^{189}\)

In *Vizcaino*, however, Microsoft could not have used APRSC because the IRS began an examination of its employment records before the defect (or misclassification) was found. \(^{190}\) Nonetheless, APRSC is a useful

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2. The percentage of plan assets and contributions involved.
3. The number of years in which the violations occurred.
4. The number of participants affected relative to the total number in the plan.
5. The number of participants affected relative to the number that could have been affected.
6. Whether correction was made prior to examination.
7. The reasons for the violations (such as data errors).

*Id.* at 187.

186. *See id.* (explaining that the APRSC is a significant step in alleviating the requirements of self-correction, but limitations to APRSC include the eligibility criteria). APRSC is applicable only to operational defects, not to form defects. *See id.* at 183. Operational defects constitute failing to follow the terms of a plan document. *See id.* The APRSC will not alleviate misclassification problems if the plan discriminates in favor of highly compensated employees, in which case the employer may need to amend the plan to cover the additional participants. *See id.* Amendments to the plan are not covered by APRSC. *See id.*

The second requirement of eligibility is that the plan administrator must show that s/he established practices and procedures reasonably designed to permit compliance with the plan qualification requirements, and that the violation occurred by oversight or mistake. *See id.* at 184.

The third requirement is that all defects must be corrected for all years, including providing all retroactive benefits to the participants that should have been included in the plan. *See id.* at 185. The most limiting aspect of APRSC is the discretionary power of the critical district offices to determine if a business fulfills the APRSC requirements. *See id.* In addition, there is no appeal mechanism after the key district office makes its determination. *See id.*

187. *See id.* at 184.

188. *See Kelley, supra* note 7, at 101. Misclassification of workers can result in disqualifying a plan. *See id.* Therefore, if the corporation takes corrective actions and provides the appropriate retroactive benefits, the plan can remain qualified for purposes of receiving the tax deductions. *See id.*

189. *See Reish & Ashton, supra* note 156, at 188 (explaining that this short “window of opportunity” is a major limitation of the utility of APRSC).

190. *See Vizcaino v. Microsoft, Corp.*, 120 F.3d 1006, 1008 (9th Cir. 1997) (en banc) (*Vizcaino II*) (noting that the IRS examined Microsoft’s records in 1989 and 1990 and decided that taxes should have been withheld and paid because the workers were employees rather than independent contractors). Microsoft’s hypothetical use of APRSC assumes, of course, that Microsoft believed the misclassification of the workers was a defect. Micro-
tool for businesses that discover that they have classified their workers incorrectly within a year of the actual misclassification.

IV. CONCLUSION

Careful preparation in drafting pension plan documents can save a business from enormous tax liabilities. IRS reclassification of independent contractors as employees creates payroll tax liabilities and jeopardizes the qualification of a pension plan, resulting in a loss of tax preferential status. Classifying workers correctly from the time of hire can alleviate certain tax liabilities. Although not dispositive, consistent language in all company literature and in contracts can help the courts in evaluating a company's intent. Ultimately, a company needs to retain the right-of-control over its employees, not its independent contractors, in order to avoid tax liability for incorrect classification.

soft conceded that the workers were misclassified for the purposes of Vizcaino II; hence, the court never resolved this issue. See id. at 1010; see also Lurie, supra note 127, at 1633 (explaining that the worker classification issue was not addressed when the Ninth Circuit Court of Appeals decided Vizcaino II en banc).