

# Plan Sponsors Beware When Classifying Independent Contractors for Benefit Plan Purposes

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**PRACTICES** Employee Benefits M&A, Employee Benefits and Executive Compensation

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Employers generally understand that "employee benefit plans" should only be provided to "employees" and that "independent contractors" should be excluded from benefit plan participation. While this concept is simple in principle, it is not as simple in application, since the determination of whether an individual is an independent contractor or an employee is not based on a bright-line test; rather, it is based on a facts and circumstances analysis. With the increase in the "gig" economy, the continued use of temporary or leased employees, and the periodic need to have an employee provide transition services on a limited basis following a termination of employment, minds can easily differ on an individual's proper classification.

To further complicate the matter, there are two different sets of rules that govern the determination of whether an individual is an independent contractor or an employee. As we noted in our Labor and Employment Group's alert (a copy of which can be found [here](#)), the DOL recently announced the publication of a proposed rule for employers to use when classifying service providers as employees or independent contractors. While this new rule, if finalized, would impact the classification of employees for purposes of the Fair Labor Standards Act ("**FLSA**"), it does not apply for purposes of the Code.

For purposes of the Code (and in turn, certain requirements of employee benefit plans), plan sponsors are required to apply a common law test that reviews behavioral, financial, and relationship factors to determine whether the degree of control and the level of independence of the service provider would merit their classification as either an employee or independent contractor. Information regarding these requirements can be found on the IRS website [here](#)

Whenever different tests are used for purposes of analyzing an issue, there is always a risk the two tests could yield different results. Accordingly, plan sponsors should separately test whether an individual is an employee versus an independent contractor for purposes of their employee benefit plans, and not just rely on the determination made for FLSA purposes. Further, even after an individual has been classified as an independent contractor, the plan sponsor may need to consider additional elements under Code Section 409A to determine whether the individual's compensation is subject to Code Section 409A (which applies to certain independent contractor relationships) and whether a person who changes status from an employee to an independent contractor has actually separated from service and is thus entitled to distributions under certain severance and nonqualified deferred compensation plans.

In order to avoid potential missteps, employers should use care when determining whether an individual is an independent contractor and maintain documentation supporting the determination of the individual's status. Plan sponsors should also review their plan documents and summary plan descriptions to ensure that if an individual is improperly classified as an independent contractor, any coverage will only be available on a prospective basis (and not retroactively). Carefully navigating these issues at the time of determination can help reduce potential challenges to an individual's status in the future.