Guide to Controlled Groups and Affiliated Service Groups

Controlled group rules apply to many types of employee benefit plans governed under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (the "Code"), such as cafeteria plans, health savings accounts, and self-insured medical reimbursement plans. The rules treat two or more employers as a single employer because of their relationship to each other if there is sufficient common ownership among them or common joint activity.

Being part of a controlled group means that all members of the group are jointly and individually liable for the obligations of the group, which could include:

- Insurance premiums
- Plan termination liability
- Pension liabilities
- Notice failures
- Nondiscrimination testing
- ACA employer shared responsibility payments
- COBRA obligations and penalties

This makes it critical for employers to understand whether they are part of a controlled group and identify members of the controlled group to be able to properly administer their plans.

The rules used to determine ownership are complex. This guide is designed to provide an overview of these rules.

Controlled Groups

Ownership interest can consist of interest in only corporations, only unincorporated businesses, or in some combination of the two. Common ownership among corporations is referred to within the Code as a "controlled group of corporations." *See Code § 414(b)*. Common ownership among unincorporated businesses or a combination of corporations and unincorporated businesses is referred to in the Code as "trades or businesses under common control." *See Code § 414(c)*. For purposes of this memo, "business" or "organization" will include corporations, limited liability companies, partnerships, sole proprietorships, tax-exempt

organizations or any other form of business entity, and any combination of the above will be referred to as a "controlled group" relationship.

Generally, there are three types of controlled group relationships:

- A parent-subsidiary relationship
- A brother-sister relationship
- A combined group

Groups of related employers may also constitute an Affiliated Service Group, which will be described in more detail later in this guide.

Parent-Subsidiary Relationship

In a parent-subsidiary relationship, one business is considered the "common parent" if it owns at least 80% of one or more of the other businesses (referred to as "subsidiaries"). There may also be multiple tiers of subsidiaries that are owned by the common parent or one or more of the subsidiaries within the controlled group structure.

A parent-subsidiary relationship will exist in connection with stock ownership with a common parent if the parent owns at least 80% of either the voting power or at least 80% of the value of the subsidiary's stock.

Example: ABC Corporation owns 80% of the only class of stock of Corporation B. Corporation B owns 40% interest in the capital interest of EFG Partnership. ABC Corporation also owns 85% of the only class of stock of Corporation C. Corporation C owns 45% of EFG Partnership. In this example, ABC Corporation is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of ABC Corporation, Corporation B, Corporation C, and EFG Partnership.

In determining ownership under the controlled group rules, only outstanding stock is considered. Excluded from consideration are:

- Stock ownership held by a plan of deferred compensation (whether qualified or non-qualified).
- Treasury stock and nonvoting stock, which is limited or preferred as to dividends.
- Restricted stock, if the employee's right to dispose of the stock is substantially restricted or limited.

If two or more U.S. companies are owned 80% or more by a foreign parent, they are still considered part of a controlled group because of the common foreign parent and as domestic subsidiaries, must still be aggregated together. This applies even though the foreign parent may not have employees who are eligible for the U.S. benefit plans. Generally, employees of a foreign parent will not impact testing because of the exclusion of nonresident aliens from testing and other purposes.

Brother-Sister Relationship

A brother-sister controlled group exists if five or fewer individuals, estates, or trusts meet both of the following tests:

- *80% Common Ownership Test*: Combined ownership of the common owners in each business must equal or exceed 80%. Common owners must have at least some ownership (either directly or by attribution) in each business being tested.
- *50% Identical Ownership Test*: Combined identical ownership of the common owners must be greater than 50%, and the same five or fewer common owners who were considered in the 80% test must also be used in the 50% identical ownership test.

Example: Tim and Shannon are owners in DEF Corporation. Tim, Shannon, and Toby are owners in XYZ Company. Since Toby does not own any interest in DEF Corporation, Toby is not a common owner.

Now assume that Tim owns 40% of DEF Corporation and 50% of XYZ Company. Shannon's ownership interest in DEF is 50% and her ownership interest in XYZ Company is 30%. Together, Tim and Shannon own more than 80% of DEF and XYZ to satisfy the 80% common ownership prong of the test.

For the identical ownership portion of the test, Tim's identical ownership in both businesses is 40% and Shannon's is 30%. The *combined* ownership is 70%, which satisfies the 50% identical ownership test. Therefore, DEF Corporation and XYZ Company are part of a brother-sister controlled group.

Combined Controlled Group

If an entity is both a member of a brother-sister controlled group and a common parent of a parent-subsidiary controlled group, a combined controlled is created consisting of all members of both controlled groups.

Attribution Rules

The attribution rules identify the legal owners of a firm and are applied differently for parent-subsidiary controlled groups and brother-sister controlled groups.

In a parent-subsidiary controlled group, the following attribution rules apply:

- If a person has an option to acquire stock, that stock is treated as "owned" by the person.
- In a partnership, a partner's ownership interest is in either the capital or profits of the partnership. Stock owned (directly or indirectly) by or for a partnership is treated as owned by any partner who has a 5% or greater interest in the partnership, in proportion to the partner's interest in the capital or profits, whichever is greater.

- In a trust or estate, stock owned (directly or indirectly) by any beneficiary will be considered owned if the beneficiary has a 5% or greater actuarial interest in that trust or estate. This, however, does not include stock owned by any employees' trust such as a 401(k) plan, defined benefit plan, or other Code §401(a) plan.

Brother-sister controlled groups must consider constructive ownership in addition to the parent-subsidiary attribution rules. Constructive ownership is an ownership interest attributable to someone other than the actual owner and depends on the type of business.

For brother-sister controlled groups, "constructive ownership" is considered. Constructive ownership is an ownership interest attributable to a party other than the actual owner, determined with reference to the type of business. Constructive ownership includes any ownership interest described above under the attribution rules applicable to a parent-subsidiary, and includes any of the following:

- Corporation – The ownership interest is in stock. An ownership interest (direct or indirect) is attributed proportionately to any person, if that person owns 5% or more of the value of the corporation's stock.
- Limited liability company – Ownership interest of an individual is generally membership interest in the LLC. However, the taxation of the LLC for federal income tax purposes should be considered in determining if membership interest is in capital or profits (if taxed as a partnership), or in voting power or value (if taxed as a corporation).
- Sole proprietorship – The sole proprietor is treated as a 100% owner.
- Individual – An individual is considered to own any stock or interest owned by the individual's spouse (except when legally separated or divorced) and children under age 21. If the individual owns more than 50% of the business, they are also considered to own the interests of the individual's parents, grandparents, grandchildren, and children over the age of 21.

In determining whether a controlled group exists, companies should be tested first by looking only at direct ownership. If the companies can be considered a controlled group based on direct ownership, there is no need to apply the attribution rules.

Affiliated Service Groups

An affiliated service group exists where two or more organizations have a service relationship, and in some cases, an ownership relationship, and where the principal business is in the performance of services, but capital is "not a material income-producing factor for the organization." *See Prop. Treas. Reg. § 414(m)-2(f)(1)*. This would include organizations in the service fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, and insurance.

There are three types of affiliated service groups:

1. A-Organization (A-Org), which consists of a first service organization (FSO) and at least one A-Org
2. B-Organization (B-Org) which consists of an FSO and at least one B-Org
3. Management groups

To be an FSO, the primary business must be the performance of personal services, whether as a corporation, partnership or limited liability company, provided that capital is not a material income-producing factor for the organization. If the FSO is a corporation, however, it must be a "professional service corporation," meaning that the corporation was or is organized under state law for the purpose of providing professional services and has at least one shareholder who is licensed or legally authorized to provide professional services.

If the entity is an FSO, you need to determine if there is also an A-Org or a B-Org group that will create an affiliated services group.

A-Org

The A-org is a service organization that is a partner or shareholder in the FSO, that regularly performs services for the FSO or is regularly associated with the FSO in performing services for third parties. The constructive ownership rules described for controlled groups still apply.

Example: Mike is an attorney who has incorporated his company as a professional service organization. Mike's company is a partner in a law firm and Mike and his company are regularly associated with the law firm in providing services to third parties. The law firm and Mike's company constitute an affiliated service group. The law firm is the FSO and Mike's company is the A-org.

B-Org

A B-org does not have to be a service organization, but must satisfy all three tests:

1. A significant portion of the B-org's business must consist of performing services for the FSO, or an A-org of the FSO.
2. Services performed must be of the type historically performed by employees in that service field of the FSO or A-org.
3. Ten percent or more of the interests in the B-org must be held (in aggregate) by officers, highly compensated employees, and common owners of the FSO or an A-org.

Example: Clinics-R-Us is a medical clinic with seven physician owners, each of whom owns 5% or more of the stock in Nurses-R-Us, a company that provides nursing services to multiple medical clinics in the area. Nurses-R-Us provides a significant portion of its services to Clinics-R-Us and is of the type historically performed by employees of Clinics-R-Us.

Nurses-R-Us is a B-Org to Clinics-R-Us, because it meets all three tests. In aggregate, more than a 10% interest is held in Nurses-R-Us by the seven physician owners of Clinics-R-Us.

Management Group

A management-type affiliated service group exists under Code §414(m)(5) when:

- An organization performs management functions, and
- The management organization's principal business is performing management functions on a regular and continuing basis for a recipient organization.

There does not need to be any common ownership between the management organization and the organization for which it provides service. Any person related to the organization performing the management function is also to be included in the group that is to be treated as a single employer.

Example: Connie is a former executive of ABC Corporation, who started her own consulting practice. Connie performs management functions and her sole client is ABC Corporation. Even though there is no common ownership between Connie's consulting practice and ABC Corporation, they are an affiliated service group.

What is the Impact of Being in a Controlled Group or Affiliated Service Group?

If two or more businesses are determined to be part of a controlled or affiliated service group, then they will be treated as one *single* employer for purposes of:

- General nondiscrimination rules
- Compensation dollar limitations
- Minimum participation requirements
- Eligibility requirements
- Minimum coverage rules
- Vesting requirements
- Contribution limits
- Top-heavy rules
- Rules applicable to SEP and SIMPLE plans
- Nondiscrimination rules for cafeteria plans, including self-funded health plans and dependent care
- Determining applicable large employer status under the Affordable Care Act and Code §4980H

The effect of being an affiliated service group is the same as for a controlled group of corporations under the Code. However, under ERISA, controlled groups are considered only in determining liability for pension liabilities under ERISA Title IV and determining multiple employer plan status, including whether an entity is a multiple employer welfare arrangement (MEWA).

There is often confusion as to whether a MEWA is a controlled group. A MEWA is a group health plan sponsored by employers that do not meet the common ownership percentage required for a controlled group. Under ERISA, a MEWA is "an employee welfare benefit plan, or any other arrangement...which is established or maintained for the purpose of offering or providing ...[welfare plan benefits] to the employees of two or more employers (including one or more self-employed individuals), or to their beneficiaries." Excluded from the

definition of a MEWA is a plan that is established or maintained under bona fide collective bargaining agreement, by a rural electric cooperative, or by a rural telephone cooperative association.

It is important to identify MEWA status because there are additional regulations and filing requirements under ERISA and state law. In addition, some states prohibit operation of self-insured MEWAs.

Conclusion

An important part of complying with employee benefit plan rules is understanding who owns the business and its corresponding employee benefit plan responsibilities. Failing to identify a controlled group or affiliated service group can be very costly. If there is any doubt regarding controlled group or affiliated group status, be sure to consult with legal counsel or tax advisor.